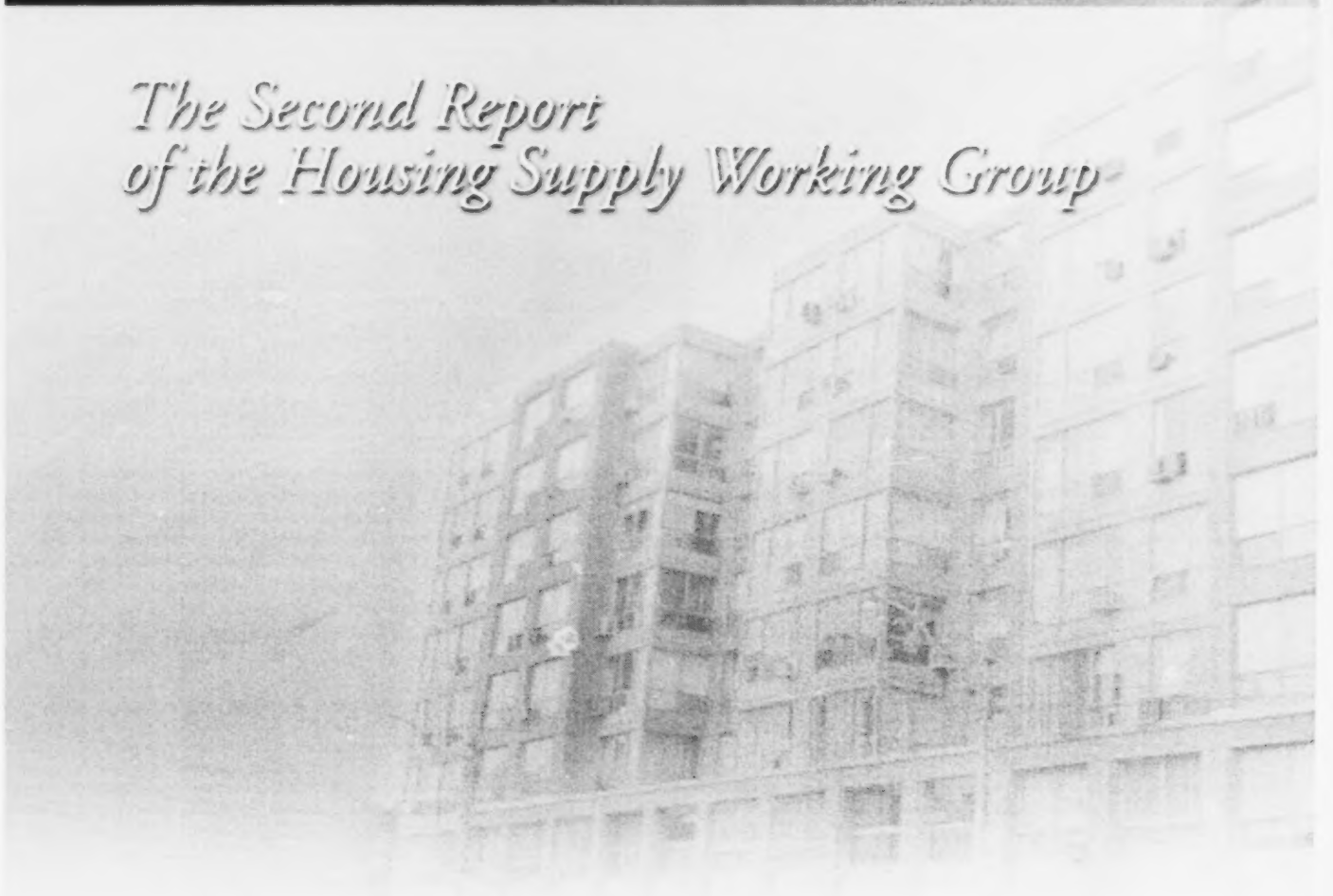
Creating a Positive Climate for Rental Housing Development Through Tax and Mortgage Insurance Reforms

The Second Report of the Housing Supply Working Group



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Executive Summary

Introduction

The Housing Supply Working Group (HSWG) is a government/industry/labour Working Group that includes senior representatives of the rental/development industry. While our primary emphasis in this report is on encouraging new rental supply, affordable housing (both rental and ownership) remains an important concern of the Working Group.

This is our second report. It focuses on the financing and taxation of rental housing, particularly at the federal level.

Our first report, *Affordable Rental Housing Supply: The Dynamics of the Market and Recommendations for Encouraging New Supply* (May 2001), made recommendations relating to the municipal, provincial and federal jurisdictions, many of which have been implemented. Other recommendations, especially those relating to the federal government, have been further developed through the Working Group's Research Subcommittee, and now form part of the recommendations of our second report.

Rental Housing: Key Issues

Ontario continues to have a serious shortfall in the production of purpose-built rental housing. CMHC data suggest a deficiency of about 14,000 new rental units per year over the next fifteen years.

The lack of interest in new rental housing investment in Ontario stems from a simple economic truth – investments of this kind have not been economically viable. Fundamental conditions in the marketplace (e.g., low liquidity/turnover of rental assets, low rates of return on capital invested, lack of access to high loan-to-value financing) are contributing factors. Equally significant are a multiplicity of changes to the regulatory and tax systems that have seriously reduced the attractiveness of investing in new rental development.

Studies commissioned by our Working Group demonstrate that changes to the tax regime governing rental housing would make the development of rental housing more feasible and would likely do so without significant negative impact on government revenues.

In order to create an environment which makes rental housing more economically feasible to build, we have concluded that *the most significant market improvements can be made through joint government action to improve the investment climate for rental housing.* While both federal and provincial levels of government have taken a number of steps to remove barriers to rental housing investment in recent years, additional measures are urgently needed to restore fundamental health to the rental housing market.

While the primary goal of the Working Group is to identify ways to increase rental housing supply, we believe that implementation of the measures recommended in this report will also improve the economics of rental housing production to the point where it will become feasible

for developers to build for the mid rent range of the market. We would like to emphasize, however, that implementation of these measures alone will not generate new rental projects which are affordable to tenants with very low incomes. No one – not the private sector, the government nor the non-profit sector – can build new housing which will be affordable to those with the lowest of incomes, unless significant subsidies are provided.

Our second report supports the intent of the new federally-initiated Affordable Housing Program[1] as an important interim measure in easing the rental housing shortage. However, we believe that only *sustained* improvements to the business climate – principally *tax reform* and *improved access to financing* – can "normalize" the economics of development to the point where privately-initiated rental development becomes economically feasible again and can begin to achieve more affordable rents. Thus, we strongly urge senior governments to adopt a more supportive tax environment for rental housing. As well, we identify improved access to financing for rental housing development, for example by easing the Canada Mortgage and Housing Corporation (CMHC) mortgage insurance terms, as a critical part of an overall strategy.

These two issues, tax reform and access to financing, fall mainly within the federal jurisdiction, and are the primary focus of this report. We also reiterate the need for the three levels of government to work together in creating a positive climate for all new rental housing development, including affordable rental development.

One component in assuring long term affordability in privately developed rental projects that has worked successfully in the U.S. is the low income housing tax credit, which provides equity for affordable housing investment. Another successful U.S. approach to financing affordable rental housing is tax exempt bonds. Tax exempt "opportunity bonds" are being developed by the provincial government. We believe housing should be considered as eligible infrastructure for financing through the proposed "opportunity bonds".

Proposed Strategy

Considering the combined advice from the three technical papers summarized in our report, we have proposed a broadly-based strategy on three fronts, each with a number of recommendations.

(1) Tax Changes to Spur Investment

Seven tax changes that the federal government could make to encourage rental investment are identified:

- a full rebate of the Goods and Services Tax (GST) on new rental housing;
- deferral of capital gains tax and recaptured Capital Cost Allowance (CCA) upon sale of a property and re-investment in new rental housing;

1 On May 30, 2002, the Province of Ontario and Government of Canada signed an agreement for the provision of affordable housing in the province. During the next five years, almost $490 million in one-time capital funding and other types of contributions will be available through this program and complementary municipal programs.

- increase in CCA to 5 per cent for new rental housing;
- restoration of soft cost deductibility up to $5,000 for new rental housing;
- elimination of the capital tax on rental housing;
- allowing small landlords to qualify as small businesses; and
- extension of eligibility for CCA losses to all investors in new rental housing.

We recommend that all seven measures be considered. Our research shows that the first four would be particularly effective. We believe that the province should also consider analogous changes, such as broadening the applicability of the Provincial Sales Tax (PST) rebate on affordable rental housing.

Cost-benefit analysis suggests that just three of the measures (full GST rebate, increase of CCA rate to 5 per cent, immediate deductibility of soft costs ($5,000)), could yield net revenues to the federal government that more than cover the revenue losses due to the changes. Production of 6,000 or more new units attributable to the introduction of the measures fully covers the costs incurred by making the changes; *development above this level generates a net gain in federal revenue*.

We recognize that the net increase in housing starts, and the corresponding impact on government revenues, will depend on the extent of the tax changes and developer assessment of the impacts for their own business case. There may also be some substitution effect wherein higher rental starts are offset somewhat by lower condominium starts. However, since there are such extremely tight rental markets in most urban centres in Canada, we believe that these tax changes will nonetheless trigger a significant increase in rental starts without major reductions in other housing starts. The revenue loss to government should be largely offset by the increased volume.

Federal tax changes will also affect provincial revenues. However, cost-benefit analysis of two of the measures (increase CCA rate to 5 per cent and immediate deductibility of soft costs ($5,000)) shows that net benefits accrue for Ontario that will largely offset the revenue losses as well.

To encourage serious federal consideration of the proposed federal tax changes, we urge the housing industry and its stakeholders to work closely with their respective Ministers of Finance and CMHC.

In addition, Ontario should discuss the adequacy of current municipal fiscal arrangements with the federal government given the local charges now required to cover the costs of growth. Ontario's discussions with Ottawa should also include the potential benefits of a low income housing tax credit to leverage private equity investment in rental projects and tax-exempt bond financing to enable municipalities to raise capital for housing and other growth-related investments.

(2) Risk Management and Project Financing

The financing options for new rental housing need to be improved. Our report proposes:

- Asking the federal government to have CMHC use surplus funds from its Mortgage Insurance Fund (MIF) and Mortgage-Backed Securities Guarantee Fund (MBSGF), to reduce its risk exposure and offer reduced premiums and more favourable underwriting criteria.
- Addressing concerns about CMHC's risk assessment of rental project loans, including access to loans and mortgage insurance, red tape, and the methods used to determine loan amounts and conditions.
- Encouraging the federal government to foster more competitive market conditions by reviewing policies that restrict competition in financial services for the rental housing industry.

Our general view is that a competitive mortgage insurance market is the best long term outcome.

(3) Collaboration and Partnership

The three levels of government must continue to work together to improve business conditions for new rental development. This matter should be part of a national agenda dealing with housing issues. Above all, governments must maintain a constant and predictable business environment.

For example, we continue to believe that uncertainty over the future of the province's *Tenant Protection Act* requirements is a significant impediment to investment in rental housing. Therefore, we continue to support the recommendation in our first report urging that "Possible mechanisms be explored which would enhance stability for investors in the future through contracts, performance bonds or other measures. Such binding assurances would improve access to capital and encourage long-term financial commitments." It should be emphasized that uncertainty with respect to rent controls is at least as significant a factor in investors' perception of the stability and riskiness of rental investment as is the tax regime to which rental housing is subjected.

In addition, the Working Group's view is that the ability to convert rental units to ownership is an important feature of the current regulatory environment and should be maintained. We welcome the response to our earlier recommendations regarding PST offset grants. Providing such grants to units in the new Affordable Housing Program is a good step, however, we also would continue to urge the government to provide sufficient funding so that the grant can be made available to *all* new rental units. As well, we continue to believe that the rebate should apply to purpose-built rental units that are condominium registered, that consideration should be given to eliminating the PST on mortgage insurance for home owners and that similar consideration be given to extending the offset grant to building materials used in the construction of affordable ownership homes.

With respect to municipal roles and responsibilities in new rental development, the potential for easing the cost burden from various municipal charges should be explored. Municipalities should be encouraged to use their existing

authority to reduce local taxes and charges, and this should be considered in the context of overall provincial/municipal fiscal arrangements.

In addition, the potential for stronger collaboration and partnership between the province and the private sector should be examined and communicated.

Conclusions

The Working Group recognizes that all levels of government are keenly aware of the importance of ensuring that business conditions for the production of rental housing are improved. Indeed, many improvements have already been made, and it is our belief that the implementation of the recommendations in this second report should form the basis for the next round of improvements. Obviously, market fundamentals in the form of interest rates, land prices and so forth will continue to be dominant factors. But even when these fundamentals are favourable, as most are today, without the kind of improvements we are advocating, rental housing may well continue to be built in very limited quantities. The changes we have proposed in this report should address this problem.

Our research to date strongly suggests that there is a good case to be made for government action in the areas addressed in this report. Improved tax treatment for rental housing, and a less onerous, more supportive mortgage insurance environment will clearly stimulate more rental housing development. Ultimately, we feel a private sector presence in the mortgage insurance market would create a competitive market that would benefit participants. It would also appear that there are some changes to the Bank Act and to capital reserve requirements for private mortgage insurers that are reasonable and which would create a more competitive financial market.

The research also indicates that for government, the cost of the proposed changes is not great. Clearly, the production of new rental units creates economic activity and additional tax revenue. Furthermore, the evidence suggests that additional revenues will make up for some, if not all, of the direct tax revenue that might be lost if our proposals are implemented.

Recommendations

1. Tax Changes to Spur Investment

Recommendation #1:

The province should table for discussion with federal/provincial/territorial partners the following changes in tax measures affecting new rental housing, in order
of priority:

- a full rebate of GST on new rental housing;
- deferral of capital gains tax and recaptured CCA upon sale of a property and reinvestment in new rental housing;
- increase in CCA to 5 per cent for new rental housing;
- restoration of soft cost deductibility up to $5,000 for new rental housing;
- elimination of the capital tax on rental housing;

- allowing small landlords to qualify as small businesses; and
- extension of eligibility for CCA losses to all investors in new rental housing.

Recommendation #2:

The Ontario Ministry of Finance should explore with the federal Department of Finance the possibility of designing a tax credit along the lines of the U.S. model (i.e., a targeted output, to low income households), with a provincial component that would allow federal/provincial sharing of tax expenditures.

Recommendation #3:

The province should, in cooperation with the Association of Municipalities of Ontario (AMO) and the municipal sector, move as quickly as possible to implement a form of tax-exempt bond financing to enable municipalities to raise capital for housing and other infrastructure and growth-related investments.

2. Risk Management and Project Financing

Recommendation #4:

The province should continue bilateral discussions with the federal government on more flexible financing terms for rental development, with particular focus on the reinvestment of Mortgage Insurance Fund (MIF) surpluses, CMHC's package of risk mitigation measures and opportunities for enhancing the flexibility of CMHC's mortgage insurance underwriting practices. More specifically, the federal government should dedicate CMHC surpluses to the MIF reserves in order to provide greater risk capacity and enable CMHC to adopt less stringent mortgage insurance requirements. CMHC should also develop mortgage insurance products particularly suited to affordability objectives such as projects serving those most in need.

Recommendation #5:

The province should urge the federal government to undertake a comprehensive review of the ways in which federal policies act to restrict competition in the area of housing financing. In particular, the federal government should be asked to review requirements for mortgage insurance on high ratio real estate loans in the Bank Act, and for additional capital reserves for lenders dealing with private mortgage insurers.

Recommendation #6:

As a contingency in the event the federal government is unwilling to consider changes to their mortgage insurance provisions, the province should hold discussions with private sector financial or underwriting institutions. Such discussions could focus on provision of mortgage insurance and/or expansion of the range of financing options available to rental developers.

Recommendation #7:

CMHC should monitor, assess and report publicly the pace and impact of the business practice changes implemented in 2002 by CMHC. These changes are an important first step and signal CMHC's willingness to adjust their pricing and underwriting policies as circumstances permit.

3. Collaboration and Partnership

Recommendation #8:

The province should ensure that business conditions necessary for stimulating new rental housing development are tabled as priority agenda items for both federal/ provincial/territorial housing discussions and for provincial/municipal discussions and that municipalities be included in discussions regarding those issues that are important to them.

Recommendation #9:

The province should continue to work with municipal partners to ensure a level playing field concerning the treatment of new rental housing projects in areas such as property tax, local development charges, approval procedures and administrative requirements.

The province should also monitor the level of municipal discretion exercised under the Fair Municipal Finance Act with respect to property tax treatment of new rental housing.

Table of Contents

1. **Introduction** 1

2. **Ontario Rental Market Dynamics** 4
   - The Rental Supply Problem Continues 4
   - The Rental Housing Shortage: Root Causes 4
   - Recent Government Initiatives to Encourage New Supply 7
   - Outlook for the Ontario Rental Market 8

3. **Removing Tax Barriers** 10
   - Key Issues 10
   - Who is Involved in Rental Housing Investment 10
   - Potential Changes in Tax Treatment for the Rental Sector 13
   - Summary Assessment of Potential Tax Changes 15

4. **Financing New Rental Development** 19
   - Concerns with CMHC Mortgage Insurance 19
   - Recent CMHC Changes 21
   - Key Factors in Providing Mortgage Insurance for Rental Development 21
   - Options for Ontario 23
   - Rental Housing Financing: Lessons Learned 25

5. **Learning from the U.S. Experience** 27
   - Differences in Rental Housing Production 27
   - Key Factors Driving U.S. Production 27
   - Lessons Learned from the U.S. Experience 30

6. **Conclusions** 34
   - Stimulating New Rental Housing Supply 34
   - Next Steps 35

7. **Summary and Recommendations** 37
   - Tax Changes to Spur Investment 37
   - Risk Management and Project Financing 39
   - Collaboration and Partnership 40

Appendix A: Bibliographic References 42
Appendix B: Interim Report Recommendations 43
Appendix C: Housing Supply Working Group Members 45

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1. Introduction

The Housing Supply Working Group (HSWG) was established by the Minister of Municipal Affairs and Housing in September of 2000 to identify barriers to the creation of rental housing and to develop recommendations respecting ways to encourage the private sector to start building rental housing again. While the Working Group's primary emphasis is on encouraging new rental supply, a related concern is the encouragement of affordable housing, both rental and ownership.

The Working Group is comprised of senior level representatives of the rental/development industry as well as other industry stakeholders. The Group includes the Fair Rental Policy Organization, the Greater Toronto Home Builders' Association, RESCON (The Residential Construction Council), the Ontario Home Builders' Association, the Urban Development Institute, the Toronto Board of Trade and the Universal Workers Union, Local 183. The Working Group was assisted in the development of this report through consultation with CARP (Canada's Association for the Fifty-Plus), the City of Toronto, the Association of Municipalities of Ontario, and the Ontario Non-Profit Housing Association, in part through the participation of these organizations in the municipal and research subcommittees of the Working Group.

The first report of the Working Group was released in May of 2001. It contained recommendations relating to the municipal, provincial and federal levels of government. Many of the first report's recommendations have been fully or partially implemented, while others, such as those relating to the federal jurisdiction, have been further developed as the Working Group's research agenda has progressed. (Table 1 provides a summary of the status of the recommendations.)

A key concern identified in the first report was the need to empower municipalities so that they could be more effective in encouraging rental and affordable housing at the local level. To this end, the province provided municipalities with extended authority to provide favourable tax treatment to new rental buildings as well as financial concessions to private sector organizations which develop affordable housing. These new powers will enable municipalities to actively participate in the new federally-initiated five year Affordable Housing Program[2]. As well, municipalities will be able to use these powers to encourage affordable rental housing outside of the program and beyond its term.

The Working Group would like to encourage municipalities to take advantage of this expanded authority to provide a more encouraging local environment for new rental and affordable housing. At the same time, however, the Working Group acknowledges that local government revenue sources are limited.

2 On May 31, 2002, the Province of Ontario and Government of Canada signed an agreement for the provision of affordable housing in the province. During the next five years, almost $680 million in one-time capital funding and other types of contributions will be available through this program and complementary municipal programs.

Table 1: Status of Interim Report Recommendations

Federal	Province and industry to work with federal government to identify tax system changes which would stimulate rental supply, including rollover provisions, pooling, passive vs active, GST, and Capital Tax. Particular attention to be given to the ability to rollover capital gains tax and the amount of allowable annual CCA deduction.	Work ongoing. Dialogue with federal government on these issues continues through the Federal/Provincial/Territorial meetings of ministers responsible for housing, and through industry presentations to the federal finance ministry.
	Province and industry to work with federal government to identify changes to CMHC lending practices which would encourage rental development, including insurance fees for high ratio loans for rental and the determination of lending value for rental.	As above.
	Federal government asked to investigate U.S. type tax incentive systems such as the Low Income Housing Tax Credit.	CMHC has commissioned additional research on the U.S. environment.
Provincial	In the absence of federal government action to address discrepancies with respect to CMHC mortgage insurance, research be undertaken to determine the feasibility of province providing mortgage insurance for rental housing construction, as an alternative to CMHC.	Addressed in detail in the report.
	Province to investigate U.S. type tax incentive systems such as the Low Income Housing Tax Credit.	Research reported in section 3 of this report.
	Province to investigate shelter subsidy programs to promote affordability in a private market.	Revised rules for Provincial Rent Supplement Program allows shelter allowances for "in situ" tenants.
	Current PST offset grant to be extended to include condominium registered rental units.	Province will be extending PST grant to condominiums under the new Affordable Housing Program.
	Program funding for PST Grant be increased so as to be available for all eligible applicants and program be extended beyond 2002.	Province will be extending PST grant to units that qualify under the Affordable Housing Program.
	Consider eliminating PST on mortgage insurance for home owners.	To date program has not been amended to include mortgage insurance.
	Consider extending PST offset grant to building materials used in construction of affordable homes.	Province will be extending PST grant to houses that qualify under the Affordable Housing Program.
	Possible mechanisms be explored which would enhance stability for investors in the future through contracts, performance bonds or other measures.	No action taken to date.
Municipal (New authority to be provided to municipalities by the province and provincial encouragement of municipal action to encourage affordable housing)	The province to provide municipalities with authority to provide favourable property tax treatment (same as ownership housing) to new rental indefinitely.	Zone Authority allows for favourable property tax treatment for 35 years).
	Province to allow municipalities to enter into agreements with the private sector for the creation of affordable housing, which would enable municipalities to provide a financial incentive to a private sector corporation for the development of affordable housing.	Zone.
	Province to review Development Charges Act, Education Act and the Planning Act to ensure that development charges, planning fees and municipal approvals do not discourage affordable housing.	To be considered in the next Working Group report.
	Further consideration to be given to the following issues at a later date: encouraging municipalities to adopt zoning that allows for accessory apartments, and encouraging municipalities to equalize tax rates between ownership and rental housing.	To be considered in the next Working Group report.

While the Working Group recognizes the Affordable Housing Program as an important interim measure in easing the rental housing shortage, only *sustained* improvements to the business climate such as tax reform and improved access to financing can improve the economics of development to the point where the market starts to function normally again – i.e., where privately-initiated rental development occurs naturally, without government subsidy.

Thus, another key concern of the Working Group was the need for a more supportive senior government tax environment for rental housing. As well, improving access to financing for rental housing development, through changes such as the easing of CMHC mortgage insurance terms was identified as critical. These last two issues – which fall largely within the federal jurisdiction – are the focus of this report. This part of our second report also emphasizes the need for all levels of government to work together in creating a positive climate for new rental housing development, particularly affordable rental development.

Our next report will focus on the municipal role in rental housing development. It will look at how municipalities have made use of the new authority that the province has made available to them. The report will also look at what else the province can do to facilitate municipal efforts to encourage rental and affordable housing development in a way that complements senior government efforts.

In refining the recommended direction for change, the Working Group, through its research subcommittee, commissioned three technical reports by consultants Greg Lampert and Steve Pomeroy. The first of these technical papers, *Options for Changes in Federal Taxes to Encourage New Rental Construction*, identifies and analyzes changes to the federal tax system with the potential for improving the investment climate for new rental housing in the province. The second paper, *The Context for Private Rental Housing Production in the U.S.* , examines the major tax and program factors in the U.S. housing industry, in terms of their impact on new rental housing development, financing and affordability. The third paper, *Promoting a Positive Mortgage Insurance Environment for New Rental Construction*, assesses the impact of the mortgage insurance requirements of Canada Mortgage and Housing Corporation on rental investment in Ontario.

Finally, the Working Group would like to thank Ontario Minister of Municipal Affairs and Housing Chris Hodgson and Deputy Minister Michael Fenn and their staff as well as staff from the Ministry of Finance for working to encourage us to provide our advice on areas of concern in the rental housing sector. We believe the conditions to create an economically feasible environment for the development of rental housing are rapidly materializing. All levels of government are now participating in the effort to improve conditions for the rental housing sector. We hope that this report will be seen as a contribution to these efforts.

We would also like to acknowledge the fine work of Greg Lampert, Steve Pomeroy and Richard Bradley and staff of the Market Housing Branch whose combined efforts allowed us to produce this report.

2. Ontario Rental Market Dynamics

The Rental Supply Problem Continues

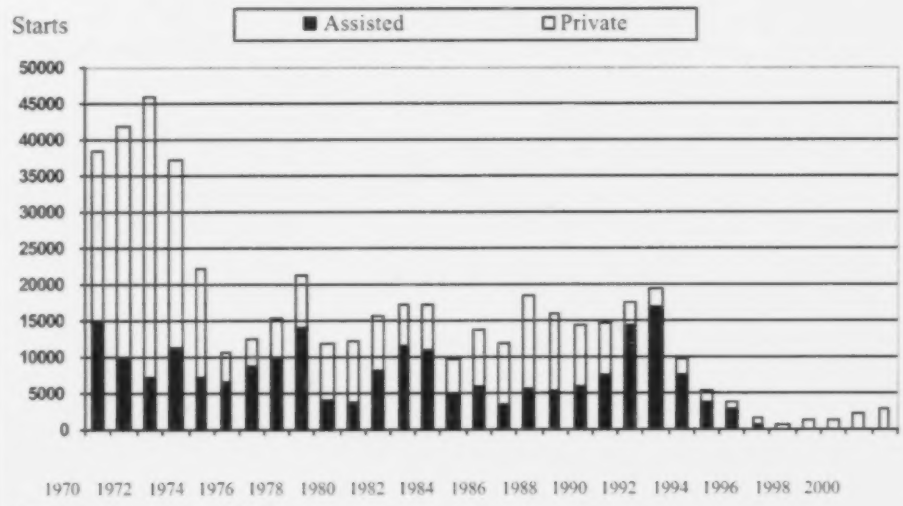
As detailed in the Housing Supply Working Group's interim report, Ontario continues to suffer from a serious supply shortfall in new rental housing production. CMHC data suggests a shortfall of about 14,000 new rental units per year over the 1996-2016 period at current rates of production. As Table 2 shows, the construction of new rental housing in Ontario has declined from an average of about 37,000 (private and government assisted) units in the early 1970s to well under 5,000 units annually (although percentage wise, private rental starts have increased significantly over the last few years.)

The Rental Housing Shortage: Root Causes

The dynamics of the rental housing shortage were discussed extensively in the first report. This section will provide a brief overview of some of the most important factors.

Rental housing is a very capital-intensive investment, but returns are insufficient to compensate potential investors for the associated risk. This is the result of an unfavourable investment climate characterized by unfavourable current taxes and other government imposed costs on rental investment and constrained access to high loan to value (LTV) financing. In many key areas of the province, the rental market is characterized by low liquidity and turnover of rental assets, limited new supply

Table 2: Government Assisted and Private Rental Starts, Ontario 1970-2001



Source: MMAH estimates and CMHC

and little choice for individuals or families seeking affordable rental accommodation.

Demographic impacts on rental housing demand

Demand factors also play a role. In addition to natural population and household growth, Ontario, and particularly its largest urban centre, Toronto, have been main destination points for immigrants to Canada for many years. The 2001 census enumerated 11,410,046 people in Ontario, an increase of more than 656,000 since 1996, the largest growth in absolute numbers among the provinces. This gain represents 57 per cent of the total growth in Canada's population between 1996 and 2001. Ontario accounted for 38 per cent of the nation's population in 2001.

The 6.1 per cent growth in Ontario's population is due to a high level of immigration, as more than one-half of the immigrants who came to Canada during the past five years settled in Ontario (Statistics Canada 2002). Concentration of newcomers creates demand pressure, especially at the low end of the rental market, and places upward pressure on rents.

Impact of federal income tax changes on rental housing supply

Rental investment has been discouraged by changes to the federal tax treatment of rental housing in the past 30 years. Particularly since 1988, these changes have made investment in rental housing less attractive and are at least partially responsible for much of Ontario's shortage of new rental investment.

Table 3 (following page) describes some of the key changes[3] to federal taxes that have significantly affected new rental investment.

The long-term negative effects of the many changes over the years have been profound for the rental housing sector – rental investment is not nearly as attractive as it was before the tax changes since the early 1970s. Analysis described later in this report will show that after-tax returns under the 1980 tax rules for three key changes (soft costs, capital cost allowance and lower federal sales tax) are about 21 per cent higher than under current rules.

From an economic standpoint, new rental construction in Ontario simply does not pay – builders have tended to turn to condominium development instead, and with diminishing experience in rental construction, may have lost some of their familiarity with the rental market and how to deal with its risks or an understanding of the long term risks/rewards.

Much that contributes to the poor investment environment for rental housing is, in fact, under government control. For example, the tax treatment of rental housing, the accessibility of competitive mortgage insurance, the uncertain and fluctuating regulatory situation, and local development charges and fees are all controlled by one level of government or another. Removing such barriers would result in significant new private rental investment. The bulk of the new investment would be at market rents less than those commonly charged in new rental projects today – which tend to be targeted to the high end of the market (where the demand for housing is relatively small).

3 This material is drawn from Lampert (1995), especially pp. 28-30.

Table 3: Federal Tax Changes

Tax reform (1972)	Rental investors can deduct capital cost allowance (CCA) from rental property income in determining their income for tax purposes. Prior to tax reform, all types of rental investors could utilize CCA deductions in excess of rental property income against income from other sources. Tax reform restricted the use of such excessive CCA deductions to principal business corporations. This removed what had been a very common investment incentive for high income investors. In addition, tax reform terminated the practice of pooling rental properties to defer recapture of depreciation upon the sale of a property. To the extent that the sale price of rental property exceeds the depreciated value, the tax payer is liable to pay tax on the 'recaptured depreciation' up to the original value of the property – beyond that is capital gains. Prior to 1972, rental investors could defer paying income taxes on recaptured depreciation on buildings sold by 'pooling' the recaptured amount with undepreciated capital on other buildings. With tax reform, taxes became payable on recaptured depreciation upon the sale of any property valued at $50,000 or more. Capital gains tax was also introduced as part of 1972 tax reform. Previously, the sale of a rental building (or any other capital property) was not subject to capital gains tax.
Syndicated rental tax shelters (1974)	The multiple residential building (MURB) provision of the Income Tax Act restored the favourable CCA treatment for individuals and companies not in the business of real estate, which had been terminated in 1972. All investors in certified MURB rental buildings could use CCA losses from rental projects to offset income from other sources. The MURB provision was extended several times – it was in effect from 1974-1979, and was reinstated for 1980-81. The purpose of the MURB provision was to stimulate investor interest in rental housing – at this it proved successful, as many syndicated MURB tax shelter rental projects were built across Canada during this period.
Reduction in CCA for wood-frame buildings (1978)	The rate of CCA allowed for wood-frame rental buildings prior to 1978 was 10 per cent, compared to 5 per cent for other types of buildings. This differential was terminated in 1978 and the CCA allowed on all buildings was fixed at 5 per cent of the undepreciated balance. Further changes were introduced in 1988 (below).
Restrictions on 'soft cost' deductions4 (1979)	Prior to 1979, certain types of soft costs were immediately deductible from rental investors' income in determining income for tax purposes. The availability of soft cost deductions was an important feature of the MURB tax shelter syndications, as described above. In 1979, rather than allow deduction of all eligible soft costs as an expense in the first year, certain deductions (e.g., fees for cash flow guarantees over a period in syndicated tax shelter rental projects) were restricted to the year in which they occurred. This change spread out the deductions for syndicated rental investments over time, and lowered the range of deductions available up-front where the risks are greater and where the impact of this kind of tax measure on investment decisions can be proportionally greater. As a result, these types of investments became less attractive.
Capitalization of many soft costs and introduction of the half-year rule (1981)	Changes introduced in 1981 required that soft costs incurred by non-PBCs be capitalized into the value of the building and depreciated over time. These changes, like the previous restrictions on soft cost deductions, were intended to help curb the use of rental tax shelters via syndication, as noted above. Subsequently, in 1988, the application of similar requirements concerning the capitalization of soft costs began to be phased in for PBCs; until that year, this rule only applied to non-PBCs. Now, and since 1992, all investors in rental properties (including rental housing and other types of rental real estate) must capitalize soft costs incurred in the construction or renovation of rental projects. Only a few soft costs (e.g., landscaping costs and mortgage insurance fees) are now deductible – most are capitalized and depreciated over time.The 'half-year rule', also introduced in 1981 restricted the CCA deductions for the year a new building was completed to one-half the normal CCA rate available (at the time, 2.5 per cent instead of the 5 per cent allowed for subsequent years).
'At Risk' rule (1986)	This rule restricted the amount which investors in limited partnerships could claim in tax benefits to the amount 'at risk'. For high-income investors, the change significantly reduced the potential tax benefits of syndicated rental tax shelters.
Reduction in CCA rate (1988)	The rate of CCA allowed for rental buildings was reduced from 5 per cent to 4 per cent of the declining balance. Consequently, under the half-year rule, CCA for the first year was also reduced to a rate of just 2 per cent.
CCA restricted to buildings 'available for rent' (1990)	The commencement of CCA deductions for new buildings was allowed only for buildings which were actually completed and available for rent.
Goods and services tax (2000)	The GST replaced the federal manufacturer's sales tax (which only applied to building materials). Prior to the 2000 federal budget, the value of a new rental building on completion was subject to the full federal goods and services tax (GST) of 7 per cent. The February 2000 budget extended the partial (36 per cent) rebate for new ownership housing to new rental construction and "substantial" rental renovations. This rebate results in an effective rate of 4.5 per cent GST payable on the finished value of rental projects. However, even with the rebate, rental developers still pay more in tax than they would have paid under the previous federal manufacturer's sales tax, which was in place before the GST. The 4.5 per cent effective rate of GST payable on new residential rental buildings contrasts to the treatment of investors in new commercial rental projects (e.g. shopping centres and office buildings) which effectively do not pay GST. Since residential rents are GST exempt, rental investors can not use the GST paid on the development of the building as a credit against GST collected on rents – as is the case with commercial rental buildings.

4 'Soft costs' are certain expenses incurred during the period of construction of a building. Included are such costs as landscaping, legal/accounting fees, building permit and development fees/levies, mortgage and mortgage insurance application fees/premiums, professional fees for architects and engineers, interest on construction financing, and property taxes payable during construction.

Removal of the barriers would make new, more modest rental projects with lower rents more economically viable than they are at present. However, none of the measures recommended in this report would be sufficient to result in new rental projects which are affordable to tenants with very low incomes. The need for housing assistance is a separate, though related, issue. No one – not the private sector, the government, nor the third sector – can build new housing which will be affordable to those on low incomes, unless significant subsidies are provided. Tenants with low incomes have an *income* problem – not a *housing* problem. Income support programs, such as shelter allowances, are a more appropriate and efficient means of providing the assistance required for low income tenants.

Recent Government Initiatives to Encourage New Rental Supply

In recent years, the provincial and federal governments have taken steps, within their respective spheres of control, to remove a number of the barriers to private sector investment in new rental supply, promote new rental housing construction and relieve pressure on the rental housing market. Ontario, for example, has implemented a number of legislative/regulatory changes and other initiatives since 1995 to encourage investment, the most recent addressing some of the recommendations of the Housing Supply Working Group's interim report (see Table 4).

Many municipalities as well are taking steps to reduce the impact of property taxes and development charges on the feasibility of new rental housing.

Federal government changes include the following:

- Following the introduction of the province's PST Grant for affordable rental housing, the February 2000 federal budget extended eligibility for the 36 per cent GST rebate to new rental housing. New **ownership** housing had always been eligible for the rebate. In effect, this change reduces the GST payable on new **rental** construction to 4.5 per cent.
- Recent CMHC mortgage insurance changes have introduced 'market-derived' capitalization (cap) rates and other modifications to its underwriting practices for new rental housing loans. CMHC has also reduced premiums for 85 per cent LTV mortgages from 5 per cent to 4.5 per cent (but raised premiums for lower LTV mortgages).
- The new federal affordable housing program, which is being done in partnership with the provinces, is an interim step to encourage the development of rental housing while all levels of government work to improve the investment climate in rental housing.

Analysis of the changes in GST application and mortgage insurance requirements suggests that there are still reasonable grounds for supporting further improvements. The reduced GST on new rental housing still leaves developers with a higher tax burden than they faced under pre-GST conditions in 1990. In addition, analysis of the impact of the CMHC mortgage insurance

changes suggests that the beneficial impact may only occur when interest rates are below 6 per cent - 6.5 per cent (depending on the term). Research done for the Working Group suggests that there will be a cancellation effect if interest rates move above this range[5]. The analysis indicates that the new minimum debt coverage ratios (DCR) will negate the benefits of the new market cap rates. Hence, if interest rates rise, investors may actually have less financing available for new rental projects than they had using the old underwriting criteria.

Outlook for the Ontario Rental Market

Continuation of the shortfall in new rental housing supply carries negative implications for the province:

- Lack of supply will place upward pressure on rents, with the result that the portion of units available at more affordable levels will continue to contract.
- Competition for existing rental housing will intensify, to the detriment of low-income tenants, and ultimately to the detriment of other program spending in such areas as homeless shelters, welfare and social services, and public health.

At the local level in Ontario, evidence suggests that municipalities are already beginning to respond to the provincial regulatory changes referenced above that permit them to reduce property tax levels and development charges (3rd and 4th items in Table 4). While it is still too early to assess the take-up of these changes or their impact on the rental housing market, there is room for optimism. A buoyant economy, historically low mortgage rates, and the directions for change proposed in this report can contribute to revitalized rental construction.

Given the relatively long period of government inactivity in encouraging the private rental housing sector through the 1980s and early 1990s, and given the current supportive economic outlook, the time is opportune for governments to again be proactive in stimulating rental development. Ontario has made, and continues to make changes to improve those areas over which it exercises some control. Within the federal jurisdiction, further improvements are also within reach, both in the tax treatment of rental housing and in CMHC's treatment of rental housing.

5 Greg Lampert and Steve Pomeroy, *Promoting a Positive Mortgage Insurance Environment for New Rental Construction, 2002*

Table 4: Provincial Initiatives to Encourage Investment in New Rental Housing

PST Grant *Partially addresses recommendations 9 and 11 of our first report which called for an extension of the Grant beyond 2002 and its applicability to ownership housing as well as rental.*	A $2,000 grant to offset the impact of the Provincial Sales Tax (PST) on affordable rental unit construction was initiated in 1999. While this program ended in March 2002, a similar PST Grant program is being developed. A recently announced $20 million investment in new funding will provide grants (also of $2,000) to offset PST costs on affordable housing units that qualify under the new Federal-Provincial Affordable Housing Program.
Reduction in capital taxes *Addresses, in part, recommendation 1 of our first report, which identified the need for change (i.e. a reduction) in a number of taxes, including the capital tax.*	A continuing move toward the elimination of capital taxes. Effective January 1, 2002, the capital tax threshold, below which no capital tax is payable, was raised to $5 million. In the recent budget, the province reiterated its commitment to eliminating capital taxes.
Period for favourable property tax treatment for new rental housing extended, *as called for in Recommendation 4 of our first report.*	A recent *Assessment Act* amendment now permits municipalities to use a separate property tax class for new rental buildings (multi-residential), retroactive to January 1, 2002, with a favourable tax rate (as low as the single-residential i.e., ownership rate) for up to 35 years (extended from 8 years). The new multi-residential class allows municipalities to apply the lower single-residential (ownership) tax rate (as with condominiums) to the multi-residential assessed value (which is lower than the ownership assessed value). In Toronto and other centres, under the new multi-residential class, the property taxes payable will be less than under either the old multi-residential class or for condominium-registered buidings.
Municipal authority to enter into agreements with the private sector for the development of affordable housing, *as called for in recommendation 5 of our first report.*	Regulatory amendments under the *Municipal Act* give municipalities authority to enter into agreements with private sector organizations for the provision of affordable housing. Municipalities can also provide financial incentives for affordable housing, in the form of reduced fees and charges, low interest loans, the elimination of taxes and reduction or waiving of development charges.
Fair Municipal Finance Act regulations require that all buildings registered as condominiums be included in the same property tax class as single residential buildings (1998).	This has meant that, in the City of Toronto, for example, property taxes on new rental projects registered as condominiums would be reduced by roughly one-half; the impact tends to be less in other centres in the province.
Tenant Protection Act (1998).	The *Tenant Protection Act* (1998) encourages investment in rental housing by allowing landlords to set market rents on vacant units and recover, at a rate of 4 per cent a year, money spent on capital improvements. (Sitting tenants are still protected by rent control, with the maximum allowable annual increase being the annual guideline increase plus the recovery of capital improvement costs, up to 4 per cent a year, if applicable).
Ontario Building Code changes (1999).	Amendments to the Ontario Building Code facilitate the creation of small single room occupancy units.
Bill 124 (An Act to improve public safety and to increase efficiency in building code enforcement, 2004).	When implemented, this legislation will streamline the building regulatory system. This is likely to reduce the cost of construction, including costs incurred in building rental housing. Bill 124 received Royal Assent on June 27, 2002 and is expected to be fully implemented by 2004.
Land use approvals process streamlined	Amendments to the *Planning Act* streamlined the planning and land use approval process, making it easier for developers to build.
Use of development charges limited	Amendments to the *Development Charges Act* to reduce the scope of services for which municipalities can levy development charges.

3. Removing Tax Barriers

In addition to raising questions about the U.S. experience and improvements to rental project financing, the Working Group's interim report proposed examination of tax barriers that constrain rental development. The report noted that historically, there have been periods when Canada's tax system facilitated rental housing development, but that many of the supportive measures have been dropped during subsequent tax reforms. Research undertaken for the Working Group enabled the development of a framework for the identification and analysis of potential changes to the federal tax system, based on the criteria of effectiveness, fairness and practicality. Overall cost-benefit and revenue impacts to the federal government were also considered. This analytical framework allowed for the development of recommendations that will strategically improve the climate for new rental investment.

Key Issues

The central issue is how to reverse the current shortfall in the development of rental housing. Adequate supply is important to both a healthy housing system and a healthy economy. The lack of sufficient investment in new rental production in Ontario's major urban centres must be fully addressed. Changes in the tax treatment of rental investment over the past three decades are at least partly responsible for the lack of new rental investment in the province. More favourable tax treatment, an important stimulus for rental investment in other countries (e.g., the U.S., Germany, New Zealand and Australia), warrants serious attention in Canada.

The impact of tax changes will vary, depending on the type of tax change and the characteristics of the investor involved.

Who Is Involved In Rental Housing Investment?

Potential changes in tax treatment will affect different players in the rental market in different ways. It is important to keep these differences among various types of investors in mind in assessing opportunities for change. Rental investors generally include:

Principal business corporations

Principal business corporations (PBCs) are corporations whose principal business is the leasing, rental, development, or sale of real property. PBCs receive more favourable income tax treatment than other types of investors in rental properties. Most of the potential federal tax measures would be positive for PBCs investing in new rental projects. One measure (extending CCA deductions to all rental investors) would be neutral with respect to PBCs since they already benefit from this measure.

Pension funds

Pension funds are not subject to income tax; income tax changes affecting rental housing would not make this type of investment any more attractive for pension funds. However, changes to the GST would have an impact in that this would affect the returns to pension funds from rental investment. There is evidence that pension funds

and other institutional investors are increasingly interested in rental housing investments.

Real Estate Investment Trusts

Real Estate Investment Trusts (REITs) invest in real estate and provide distributions to unit-holders based on the resulting income. REITs do not pay tax on their income; instead, the income flows through to unit-holders and is taxed in their hands. The income is a combination of tax-free 'return of capital', which is not subject to income tax, and other income, which is taxable. Unlike the case with PBCs, many of the potential federal tax changes would not affect REITs investing in new rental projects.

Non-profit corporations

Non-profit corporations do not typically pay income tax on their investments, so they would not benefit directly from any of the potential measures with respect to the income tax treatment of rental housing. Non-profits could benefit indirectly from the deferral of recaptured depreciation and capital gains taxes to the extent that the measure might create an additional 'supply' of existing rental projects which might be suitable for purchase by non-profit organizations. Non-profits would benefit from the GST change (as well as changes to mortgage insurance requirements discussed elsewhere in the report).

Other corporations

Companies which own (or seek to own) real estate, but are not classed as PBCs, would benefit from all of the potential federal tax measures proposed in this summary report.

Individuals

Most of the potential measures would be positive for high-income individuals interested in investing in rental housing. However, there are also a lot of small investors in rental housing. It is estimated that about one half of the private rental stock in Canada is owned by small investors who each own from 1-6 units[6]. There would seem to be niche opportunities for small investors in new rental development particularly for smaller infill and intensification projects.

PBCs are the investor category most likely to have the combination of talents and resources required to undertake the development of new rental housing projects. However, past experience would suggest that individual high-income investors could also be attracted to syndicated investments in rental housing – provided there were sufficient tax shelter benefits. PBCs and (to a lesser extent) individuals are the primary focus of the analysis of potential federal tax changes in this section.

In considering the potential to stimulate *new* rental development, PBCs are considered the most promising types of investor to encourage. Institutional investors such as REITs and pension funds (the other major investors in rental housing) generally prefer to acquire *existing* rental properties, which tend to be less risky since they have a stabilized income stream and known operating history. The non-profit sector is best encouraged to build through direct program support or through partnerships with private developers. We do not

7 Clayton Research Associates Ltd. and Fish Marks Jenkins Real Estate Consulting (1999) *Understanding Private Rental Housing in Canada*, pp. 4, 45-46.

recommend a return to direct program funding as characterized by the social housing program of earlier years. However, it may make sense in many cases to encourage the non-profit sector to bypass the "developer's risk" and pursue a role, through purchases or long term leases, as managers of affordable and supportive housing rather than as builders.

In proposing options for change, it is important to emphasize the difficulties that have developed with respect to the tax treatment of rental housing. These include:

- the inability to defer capital gains and recaptured depreciation upon re-investment in rental property (unlike other types of capital investments);
- the application of an effective 4.5 per cent GST rate to rent (unlike other types of rental real estate investments (e.g., commercial) which effectively do not pay GST because they can claim offsetting GST inputs);
- the inability of businesses that invest in and manage rental properties to qualify for the small business deduction (unlike other businesses that require hands-on management); and
- the lack of tax benefits from investing in rental properties (unlike some other types of capital investments which enjoy favourable tax treatment.)

The suggested changes in this report, by themselves, will encourage investment in new rental housing. The net increase in rental units will, however, depend on the extent of the tax changes, and developers' assessment of the impact of the changes on their potential investment. While there may be some substitution effect (whereby higher rental starts are partly offset by lower condominium starts), given the extremely tight rental markets in Canada, there would appear to be considerable room for a large increase in rental starts without significant reductions in other housing starts. At present, the economics favour investment in high-end rental properties. *But these favourable tax changes cumulatively will also encourage developers to move towards the mid-range of the market, where rents will be more affordable – an outcome that is especially attractive in many areas of the province where vacancy rates are low and demand for modestly priced rental housing is high.*

Such a market is inherently less risky for the investor than the luxury market where the volume of demand is limited and potential competition from condominiums is a major concern. Policy makers should remember that the competitive nature of the market is such that these changes will not just improve investment returns for developers and owners; they will also create more housing including more affordable housing. Tax changes will not only lower the rent threshold at which a new project will be viable (i.e., at *more* affordable rents, if not *affordable* rents), while at the same time new supply will help to reduce demand pressures and, by displacement, increase the supply of vacant units in the existing stock. It should also be noted that where governments choose to provide further rent supplement or shelter subsidies for those most in need, the lower rents will reduce their annual subsidy costs.

Potential Changes in Tax Treatment for the Rental Sector

The following potential changes in the tax treatment of rental housing, *in order of priority for implementation*, were reviewed and assessed against effectiveness, fairness and practicality criteria for the Housing Supply Working Group.[7]

Fully rebating new rental housing for the purposes of the GST

Currently, GST is payable at an effective rate of 4.5 per cent on the development costs of new rental housing; no GST is paid on the sale of existing rental buildings. The analysis compared GST rates for new rental buildings with the pre-GST manufacturers sales tax, and with current GST treatment of businesses similar to rental housing, GST-exempt businesses and other basic necessities, like groceries. A full GST rebate can be argued as an effective and more equitable measure, in stimulating interest in rental housing investments. The analysis argues against pressing for zero-rating (i.e., no GST on development or operation) of rental housing for GST, on the grounds that the revenue impact of zero-rating would be too broad (i.e., it would affect *existing* as well as *new* rental, with large foregone revenue implications). It would be more practical to be able to target a GST rebate to development costs of new rental housing, where the greatest benefits, in terms of encouraging rental investment, can be realized. A full GST rebate would lower the total cost of development, which would reduce the equity needed, the mortgage amount and mortgage insurance fees, thereby improving the economic viability of new rental projects leading to feasible returns and a more attractive investment climate overall.

Allowing rental investors to defer capital gains tax and recaptured depreciation upon the sale of a rental project if the proceeds are reinvested in new rental housing

Under current Canadian rules, sale of a rental housing project triggers taxes on capital gains and recaptured depreciation. In the U.S., rental housing qualifies for deferral of capital gains and recaptured depreciation if another property of greater or equal value is purchased. Allowing tax deferral when a building is sold, as long as the proceeds are reinvested in another rental project, would be an incentive for long-term investors to adjust and rebalance their portfolios, in keeping with changes in the marketplace and their own investment goals. Turnover in the rental market increases liquidity and creates opportunities to invest in refurbishment of existing stock and in new rental supply. Allowing tax deferral for rental housing would also provide greater consistency in terms of how other types of capital investments are treated. This measure would help to unlock the existing reluctance of investors to sell properties and invest in new rental housing because of the negative tax consequences.

Increasing the rate (from 4 per cent to 5 per cent) for capital cost allowance (CCA) on new rental housing

The allowable CCA for rental projects in Canada is 4 per cent of the declining depreciable balance annually; for new rental projects, a "half-year

7 Greg Lampert and Steve Pomeroy, *Options for Changes in Federal Taxes to Encourage New Rental Construction*, 2002

rule" applies (i.e., 2 per cent CCA rate for the initial year). Raising the CCA to 5 per cent would encourage investors, as it would increase the deductions available to investors in the critical early years of a project. Increasing potential returns in the early years acts as an encouragement to investors to accept the risks associated with new rental development. From a cost perspective, deferred tax revenue does not represent lost tax revenue, as it is eventually recouped when buildings are sold; accelerated depreciation simply lowers tax owed in the short term. An increase in the CCA rate would increase after-tax returns and thus provide a potential stimulus to new rental investment.

Allowing investors to deduct soft costs rather than capitalize them

"Soft costs" include legal, accounting, and professional fees, landscaping and various other charges related to the construction of a building (see footnote 3). Since 1992, all investors in rental properties have had to capitalize soft costs related to construction or renovation of rental property. Restoring soft cost deductibility would increase the negative income (i.e., tax losses) in the first year and allow investors to reduce their taxable income from other sources, an attractive benefit for rental housing investments. With potential for higher after-tax returns, this measure would be beneficial to rental investors. Any measures that have a positive effect on the marginal returns usually experienced by rental developers in the early years of a project can have a disproportionate impact on the decision to build or not to build. Introducing this measure could have significant implications for government revenue, unless its application is restricted to new rental housing projects, as opposed to other types of rental real estate.

Exempting rental housing from capital taxes

Federal and provincial governments assess capital taxes against large corporations, including those that invest in real estate, based on the total capital (i.e., equity, mortgage loans and retained earnings). Capital taxation is controversial; many feel that it discourages investment, since it is applied without regard to the economic cycle, and that it discriminates unfairly against capital-intensive industries. In 1999, Ottawa collected around $1.5 billion in capital taxes; the provinces collectively received about $3.9 billion. In the fall of 2001, the House of Commons Finance Committee advised the federal government to eliminate capital tax on all corporations' assets, but in the most recent budget the federal government did not act on this advice. The federal government has taken the position that the provinces should take the initiative in cutting their capital tax; the federal capital tax rate is already lower than the provincial rate and the threshold on which it is payable (over $10 million) is higher. Ontario is moving towards eliminating the tax – the 2001 provincial budget removed the tax on the first $5 million of taxable capital, effective January 1, 2002. Both the federal and provincial governments should eliminate their respective capital taxes.

Allowing small landlords to qualify as small businesses for the purposes of obtaining the small business corporate tax rate

Unlike other small businesses, small corporate rental investors are specifically excluded from the favourable tax treatment afforded other small businesses by the small business deduction – unless the rental company has more than 5 full-time employees. As is often noted, the small business sector is one of the most important engines of growth and job creation in free market economies. Small landlords account for a significant share of the rental housing stock, and they are potential candidates to build more rental housing. The ability to qualify for the small business deduction would make the after-tax returns from rental property investments more attractive to small corporations. Allowing small corporate landlords to qualify for the same favourable tax treatment as other small businesses could encourage them to become involved in building much-needed new rental housing.

Allowing all investors in rental housing to utilize CCA losses in determining income for tax purposes – not just principal business corporations (PBCs)

Currently, only principal business corporations (PBCs) and life insurance companies are eligible to use CCA "paper losses" over net income as a deduction against income from other sources. Non-PBCs, partnerships and individuals can use CCA losses only to reduce net income from rental properties to zero for tax purposes – they cannot create "paper losses". While PBCs are the most likely investors in new rental housing because of their expertise and knowledge in this area, they are not the only potential investors. For individuals and non-PBCs, rental housing investment would be more attractive if CCA losses could be claimed against other income. In particular, syndicated tax shelters, which combine developers' expertise and the financial clout of individual investors could provide a much-needed boost to rental production if CCA losses were allowed to be used as deductions against other income – the experience of the MURB programs is instructive in this regard. As with the soft cost measures, because of significant implications for government revenue, this change would be limited to new rental housing developments.

Assessment of Potential Tax Changes

Analysis of the potential tax changes included their evaluation in terms of:

- Effectiveness – whether the measure will improve the investment levels and result in increased new rental production.
- Fairness – whether the measure will be justifiable in terms of equity with other similar types of investments.
- Practicality – whether the measure will be simple to implement and have potential for targeting most of the benefits exclusively to investors in **new** rental housing.

Table 5 on page 26 presents an overview of the assessment of each of the seven potential changes in federal taxes on rental housing, based on the above three criteria. This exhibit also lists the measures in order of priority based on the overall assessment across all three criteria. Although each

change can be taken on a stand-alone basis, a combination of measures would clearly have a greater impact on new rental development than implementing only one measure.[8]

For the criterion of effectiveness, the table quantifies the effect of each change, where this is possible. The estimates are based on an illustrative new Toronto rental project pro forma. For each measure, the impact on taxable income and after tax cash flow is estimated. This is presented for the initial year of operation, as well as on a 25-year present value basis. The longer-term present value assessment is considered more meaningful than an initial operating snapshot, especially in the case of *potential* measures where tax liability is deferred. In the case of the GST rebate, the table also shows the change in the level of equity required.

In some cases, it is neither feasible nor practical to develop a detailed cost impact, as there are too many unknown variables that influence the result.

Effectiveness

All of the potential tax changes are considered likely to have some effect in generating new rental production. The impact will vary across measures, with some having a broader impact than others.

The full GST rebate immediately lowers the level of investor equity required and has a further positive impact on investors' return on equity. This measure would benefit *all* types of rental investors, not just the ones who pay income tax. Restoring soft cost deductibility has the largest quantifiable impact on after-tax income in the critical first year following project completion. In terms of after-tax cash flow over time, the full rebate of GST and increasing the CCA rate from 4 per cent to 5 per cent have the largest impact of the three potential changes for which impacts can be quantified.

From the analysis undertaken, *fully rebating the GST on rental housing, deferral of capital gains tax and recaptured depreciation (upon reinvestment in rental housing), increasing the CCA rate, and restoration of soft cost deductibility* are the most effective measures for stimulating new rental investment. The other measures have a positive impact and would be effective complementary measures, but alone are not considered likely to have as significant an impact.

Fairness and equity

Five of the seven measures examined would rectify some degree of inequity in the current tax environment, compared with the tax treatment of other types of investments:

- fully rebating GST on new rental housing;
- allowing deferral of capital gains tax and recaptured depreciation upon sale of a property and re-investment in new rental housing;
- increasing the CCA rate to 5 per cent for new rental housing;
- allowing small landlords to qualify as small businesses; and
- extending eligibility for CCA losses.

8 Table 5 and a fuller analysis are presented in the Lampert and Flaherty, *Options for Changes in Federal Taxes to Encourage New Rental Construction* (see pp. 56-57). The paper examines the impact of individual tax changes on a standard project "pro forma". Columns 2 and 3 of Table 5 are derived from this data.

Table 5: Assessment of Potential Tax Changes

	Effectiveness				Fairness	Practicality	
	Per Unit Change in After-Tax Cash Flow ($)*		Change in Per Unit Initial Equity ($)	Effect in Generating New Rental Investment		Simple to Implement	Easily Restrict to New Rental Housing
	Year 1	PV (25 yrs)					
Full rebate of GST on rental housing	182	2,597	2,553	Both lowers equity required and improves cash flow	Rental housing investors treated very differently from both other types of rental property, and other basic necessities (e.g. groceries)	Yes	Yes
Deferral of capital gains tax and recaptured CCA upon re-investment in rental housing	n/a	n/a	-	Difficult to quantify but provides important new source of investment capital	Rental property currently treated differently from other types of capital assets	Yes	Yes
Increase in CCA to 5%	213	2,079	-	Improves after-tax cash flow	Accelerated CCA allowed for some other types of investments	Yes	Yes
Restoration of soft cost deductibility ($5,000)	1,721	1,129	-	Improves after-tax cash flow	No evident unfairness	Yes	Yes
Elimination of capital tax on rental housing	n/a	n/a	-	Improves after-tax cash flow	No evident unfairness	Yes	Yes
Allowing small landlords to qualify as small businesses	n/a	n/a	-	Limited number involved in new development	Investors in rental housing appear to be treated differently from other types of small businesses requiring hands-on management	Yes	No
Extension of eligibility for CCA losses	n/a	n/a	-	Yes (for non-PBCs)	Life insurance companies are allowed to use CCA losses against other income	Yes	Yes

* The change in after-tax cash flow (compared to the current tax treatment) for a Toronto rental project with development costs of $141,400 (excluding GST)

Practicality

In the case of the CCA revisions, analysis included examination of a number of broader options, in addition to increasing the rate to 5 per cent. These options included relaxing the half-year rule, and changing the method from a declining balance to straight-line depreciation, as in the U.S. model. Since these options would entail fundamental change across the entire Canadian income tax system, they were not considered practical; for this reason, only the increase in the CCA rate to 5 per cent, which can be implemented solely for new rental housing, is proposed.

As noted above, zero-rating rental housing can be justified on the basis of fairness (compared to both commercial real estate and other basic necessities including food), but may not be practical due to the significant administrative and revenue impacts of such a change for the federal government. Therefore, full rebate of the GST on the development cost of new rental housing is proposed.

From a practical standpoint, all other potential tax changes are readily implementable. They would require relatively routine changes in tax policy and procedures. Similarly, most measures can be restricted so that, if desired, their benefits could

specifically target new rental production. This approach would help to ensure that the impacts are well targeted and would contain the associated impact on federal tax revenues.

Overall cost-benefit of proposed tax measures

From a cost-benefit perspective, the three quantifiable measures (full GST rebate, increase of CCA rate to 5 per cent, immediate deductibility of soft costs) can be shown to provide net benefits that would at least partially offset or more than cover the costs of the tax changes.[9] *For these measures, production of 6,000 or more incremental units (i.e., additional new units that are attributable to the introduction of the measures) fully covers the costs incurred by extending all three changes, when they are applied across a base forecast for 2002 of 21,500 units.*[10] Development over and above this level would generate an overall net gain in federal revenue even if there is some offset due to substitution (some developers may simply switch from building condominium units to new rental). The pent up demand for rental housing suggests there will be considerable net new housing built. This in turn means that even if the threshold of net positive revenues is not reached (6000 net new units according to our analysis), the negative impact on tax revenues will be considerably reduced.

The analysis also looked at differences between the current taxation environment for rental housing versus the tax system in place prior to the changes in the tax rules in the 1980s and 1990s. Based on an illustrative analysis of the impact of three key changes (soft costs, CCA and lower federal sales tax) on the after-tax cash flow from rental investment in the two periods, it is quite clear how much the changes in the tax treatment of rental housing since the 1970s have dampened the potential returns from rental investment – and therefore the attractiveness of rental investment. The present value of after-tax cash flow (for the three illustrative changes) from an investment in a new rental project in 1980 was roughly 21 per cent higher than it is under current tax rules.[11]

There have also been some more positive changes in the tax environment during this time period – notably reductions in personal and corporate tax rates. The higher corporate tax rates prevailing in1980 would have reduced the investment returns in that period. However, the higher tax rates would have applied to all types of corporate income so it would appear that the relative attractiveness of rental investment compared to other types of investments would have been better in 1980 than today.

In combination, the tax stimulus measures identified will yield positive outcomes in terms of higher rental production, greater liquidity in the rental housing market, a healthier housing marketplace, reduced upward pressure on rents and, it would appear from the research, the reduction in federal and provincial revenues associated with the measures would be at least partially offset by the increased revenues generated from higher levels of rental production.

9 The cost-benefit analysis of these tax measures is provided in *Options for Changes in Federal Taxes to Encourage New Rental Construction.*

10 New rental production in Canada for 2002 is forecast by CMHC to include about 13,500 purpose-built rental starts; in addition, assuming that 25 per cent of condominium development will be for the rental market yields about 8,000 rental condominium units, for a total of 21,500 units in base forecast rental production.

11 See *Options for Changes to Encourage New Rental Construction*, pp. 44-45.

4. Financing New Rental Development

The Working Group's first report called for further study of CMHC mortgage insurance practices with respect to new rental housing (e.g., insurance fees for high-ratio loans and the determination of lending value for rental housing). The first report also recommended examining the feasibility of the province facilitating the provision of mortgage insurance for rental housing construction – either directly or in partnership with CMHC.

Concerns with CMHC Mortgage Insurance

CMHC Mandate: Overview of Stakeholder Concerns

In Canada, builders and investors who may be interested in new rental development face a number of systemic barriers in securing financing for rental projects. Up front, they require a great deal more equity than builders of ownership housing require – they have to commit more capital for the long term. As well, mortgage insurance is a key element in securing financing for new rental development, and CMHC mortgage insurance is the only game in town. Industry stakeholders – lenders and potential investors – have mixed views about CMHC's role in providing mortgage insurance. On the one hand, CMHC insurance provides access to high-ratio financing, lower interest rates and greater leverage than would otherwise be possible. On the other hand, the process for loan valuation and associated negotiations is seen as unnecessarily difficult and uncertain. Stakeholders would prefer less red tape, more flexibility in the application of underwriting criteria, lower premiums and more predictable turn around times from CMHC.

Concerns about CMHC operating on a 'commercial basis'

CMHC's mandate includes providing mortgage insurance on a 'commercial basis', and CMHC's premiums and underwriting criteria probably reflect this requirement. The reasonableness of CMHC's loan approval requirements, weighed against the substantial risks associated with loans on new rental housing projects, is hard to assess without the actuarial data behind their decisions.

Regardless, some stakeholders interviewed questioned why a critical function like mortgage insurance is retained in a publicly owned corporation with a commercial mandate. This may at times place CMHC in a conflict – its commercial mandate serves to constrain its ability to carry out its other mandate, that of facilitating an effective housing market, including the financing of new rental housing. Despite its central mandate to offer mortgage insurance commercially, some feel CMHC's other main role of facilitating a strong housing market has been underplayed and that the large surpluses projected for the Mortgage Insurance Fund (MIF) and the Mortgage-Backed Securities Guarantee Fund

(MBSGF) are counterproductive and in part generated by overly cautious underwriting requirements and unnecessarily high premiums. The Working Group feels that the CMHC mandate to support public policy goals should be on the table for federal/provincial discussion and that the surpluses being generated by the mortgage insurance and mortgage-backed securities funds should be used to strengthen the reserves and correspondingly to allow for lower premiums or more flexible underwriting criteria.

Concerns about CMHC surpluses

Surpluses generated in CMHC's MIF are appropriated to provide additional insurance reserves, as a form of 'rainy day' account for high default lean years. These reserves are based on an actuarial analysis developed by the Office of the Superintendent of Financial Institutions. In 2000, reserves in the MIF totalled $3.5 billion. Surpluses remaining after this allocation may be appropriated as federal revenue or retained by CMHC, as authorized by the federal government. CMHC also operates the MBSGF that in recent years has generated a surplus balance.

In the three years, 1998-2000, the applicable year-end surpluses from these two funds were significant, as Table 6 shows.

The MIF appropriated balance has climbed significantly in the past couple of years and for 2001 should be near $1 billion. Further, the 5-year projection from CMHC's corporate plan, 2002-2006, is for a total surplus of over $3 billion by 2006. Economic growth, high employment, low interest rates and high demand from bolstered consumer confidence have undoubtedly influenced the surplus situation. The year 2000 was the best year for the housing industry since the mid-1990s – positive market conditions likely contributed to fewer defaults and a reduced draw on CMHC reserve funds.

The federal government should consider assigning the total surplus to the actuarially required CMHC reserves. *By making greater provision for downstream risk, CMHC would be in a position to reassess current risk mitigation measures and take a less conservative approach in underwriting new rental development projects.* This represents an opportunity, which would allow CMHC to strengthen its support for public policy under

Table 6: CMHC Mortgage Insurance Fund and MBSGF Surplus[12]

Year	MIF Surplus ($M)	MBSGF Surplus ($M)	Total
1998	276	44	320
1999	538	55	593
2000	940	66	1006

12 Table 6 is derived from CMHC 2000 Annual Report, financial statements; CMHC (2001) p. 63.

CMHC's mortgage insurance practices, as articulated in its corporate objectives and major lines of business.[13]

Recent CMHC Changes

As noted previously, CMHC's expertise, underwriting infrastructure and mortgage insurance practices, especially concerning the determination of lending value, insurance premiums and underwriting criteria, are key factors in the Canadian housing marketplace. CMHC has responded to criticism of its mortgage insurance underwriting criteria and premiums by introducing changes that reduce premiums for high-ratio 85 per cent loan to value (LTV) mortgages slightly (from 5 per cent to 4.5 per cent), but raise premiums for 71 per cent – 80 per cent LTV mortgages. In addition, CMHC's underwriting practices with respect to loans for new rental housing now use 'market-derived' capitalization (cap) rates and modified debt coverage ratio (DCR) requirements for new rental loans.

The move to a market cap rate is a significant improvement from the former 'official' policy of using a minimum 9 per cent cap rate. However, analysis suggests that changes in the minimum DCR requirement, from a standard DCR of 1.1 (for a 35 year term at 9 per cent) to 1.3 (mortgages with terms under 10 years), and 1.2 (mortgages of 10 years or more), may actually undermine the effect of using market cap rates.[14] The new underwriting criteria will not result in higher loan amounts for rental properties if interest rates rise above their current low values. As well, if rental investors attempt to 'lock-in' interest rates for when a project is completed, the new DCR requirements may lower the mortgage amount to less than what would be available using previous underwriting criteria.

The changes in CMHC's mortgage insurance premiums and underwriting practices will help to address some of the concerns raised in the Working Group's first report. However, whether the changes will actually result in greater access to mortgage financing for rental developers or just lead to a temporary respite during the current extremely low interest rate environment remains to be seen. Clearly, a federal move to add all or some of CMHC's accumulated surpluses to the insurance reserves would alleviate some of CMHC's concerns about risk management, and allow CMHC to consider further flexibility in risk mitigation.

Whether other concerns raised by stakeholders will continue to frustrate developers seeking mortgage insurance for rental development also remains to be seen. Although CMHC policies continue to be a concern, reports suggest that changes implemented in the Ontario office are responding to criticisms regarding the need for better 'customer service'.

Key Factors in Providing Mortgage Insurance for Rental Development

Before considering some of the options for improving the financing available for rental housing development, it is instructive to look at the central factors at play with respect to how

13 Under the CMHC 'Housing Finance' business area, for example, CMHC commits to contributing to increased competition and to the 'well-being' of the housing sector in the national economy; CMHC (2001) p. 7.

14 Greg Lampert and Steve Pomeroy, *Promoting a Positive Mortgage Insurance Environment for New Rental Construction*, 2002, pp. 16-18.

mortgage insurance for rental housing is currently provided:

The risks of mortgage insurance

Investments in new rental projects are inherently risky. Markets soften and rental projects sometimes fail. This is especially so with *new* rental projects, which are launched on expectations of achievable rents and expected construction costs, which are by no means guaranteed. Worth noting is that GE Capital Mortgage Insurance Canada (GEMICO), which competes with CMHC in the mortgage insurance business for ownership housing, does not currently offer insurance for rental project loans – nor does their U.S. parent company. This reluctance may stem from start-up issues (e.g., issues of starting a new product line or of "adverse selection", with CMHC taking the bulk of low-risk loans), or from perceived lack of profitability in mortgage insurance. This is despite the relatively high premiums charged by CMHC, its only competitor.

Also noteworthy is the fact that in the U.S. there are several large private corporations that offer mortgage insurance on ownership housing, but not on multi-family rental loans. Only the U.S. government (Department of Housing and Urban Development, under the Federal Housing Administration) provides rental mortgage insurance, and then on subsidized terms to promote specific public policy objectives (e.g., rental housing targeted at low-income tenants). This raises a concern that there may not be sufficient profitability in the rental mortgage insurance business to justify the initiation of private mortgage insurance. Clearly, this is a complex field where the potential losses are significant, unless prudent underwriting practices are employed.

The extensive underwriting infrastructure of CMHC

Although the development industry may not like CMHC's mortgage underwriting and premium structure, it would be difficult, and costly, to replicate the expertise and analytical capacity within CMHC by establishing a provincially run mortgage insurance function, as was suggested in our first report. Again, the priority should be on federal authorization for CMHC to assign MIF surpluses to ameliorate risks and provide premium reductions, or relaxation in the severity of the underwriting criteria. If, however, the federal government is unwilling to consider such a move, an alternative to forming a competitive provincial agency is available. The province could, for example, establish closer ties with commercial ventures that might be willing to develop competitive rental housing mortgage insurance products.

The federal government guarantee

CMHC-insured mortgages enjoy the 100 per cent backing of the Government of Canada – the most credit-worthy agency in the country. In the case of catastrophic risk, where claims could exhaust CMHC's MIF, lenders are assured that the Government of Canada would meet any outstanding liability. While the province of Ontario also enjoys a strong credit rating, it is generally not considered as highly rated as that of the Government of Canada. Mortgages backed by the Ontario government would likely not be considered as low a risk as those backed by the

Government of Canada – and, accordingly, the risk-adjusted mortgage interest rate to the borrower would not be as low.

Options for Ontario

The province should continue to lobby for more creative uses of CMHC insurance (and the MBSGF) fund surpluses, more flexible insurance terms and improved financing services. If the situation warrants, the province should also move forward with discussions to encourage the private sector to enter the mortgage insurance field and in this way let a competitive marketplace create the most efficient conditions. A final option, but one that is not recommended by the Working Group, would be for Ontario to set up its own mortgage insurance operation.

The province should also urge the federal government to undertake a comprehensive review of the ways in which federal policies act to restrict, rather than open up, reasonable competition in the area of housing financing. Two examples of restrictive policies are the requirements for mortgage insurance on high ratio real estate loans, and the additional capital requirements for lenders dealing with private mortgage insurers (e.g., GE Mortgage Insurance Canada):

- Changing the *Bank Act* to allow lenders to offer higher ratio property loans without requiring mortgage insurance should be explored. Federally-chartered lenders are currently not allowed to make property loans in excess of 75 per cent of property value without mortgage insurance. With no competition, this means that CMHC is the only option available for borrowers seeking high-ratio loans. In the U.S., lenders regularly provide financing equivalent to 80 per cent of property value without mortgage insurance. It may be time to revisit this requirement and allow lenders to take on the additional risk associated with high-ratio loans without requiring mortgage insurance. This would permit the market to price risk and would provide an alternative risk assessment to that undertaken by CMHC.

- Mortgage lenders are required to hold a portion of capital in reserve when dealing with private mortgage insurers. This is unlike the case with CMHC-insured loans, which are 100 per cent guaranteed by the federal government. Therefore, lenders may offer less attractive interest rates for privately insured mortgages compared to those with CMHC insurance. For large rental projects, even a modest difference in interest rates represents a significant disadvantage for private mortgage insurers and a disincentive for them to offer mortgage insurance for rental projects.

Without access to CMHC's detailed actuarial analysis, it is not possible to undertake a comprehensive assessment of CMHC's risks in offering mortgage insurance on rental housing projects – or whether the current package of risk mitigation measures used by CMHC is appropriate. Greater transparency in this regard would be beneficial. It would be instructive to learn the extent to which current CMHC practices are based on CMHC's past default experience – this is relevant since loans advanced in the pre-1995 period, before substantial changes in CMHC's mortgage insurance practices for rental housing were introduced, offer little insight to likely defaults today since the underwriting criteria are now so much more strict.

The risk mitigation measures currently used by CMHC include *all* of the following:

- a substantial mortgage insurance premium (e.g., 4.5 per cent of the loan amount for 85 per cent LTV loans – i.e. $4,500 per unit for a mortgage of $100,000 per unit);
- a requirement for investors to have a minimum 15 per cent equity in the project;
- market-based lending values (based on current market cap rates);
- minimum DCR requirements (project net operating income must be at least 20 per cent higher than the mortgage payment – 30 per cent higher in the case of loans with terms of less than 10 years);
- rental achievement holdbacks (i.e., the full amount of the loan is not advanced until the project has been operating for at least a year at the projected rents); and
- investor (often personal) guarantees.

While some such measures are important for prudent risk management, there would appear to be a case for examination of whether *all* of the above measures are required in all circumstances. For example, with appropriate underwriting (to determine the loan amount), the requirement for at least 15 per cent investor equity, rental achievement holdbacks, plus personal guarantees, there would appear to be a case for some flexibility on the DCR requirements. Similarly, if all of the other risk mitigation measures are in place (e.g., equity, market based lending value, DCR requirements, rental achievement holdbacks, plus guarantees), there may be a case for a lower mortgage insurance premium.

Given the evident profitability of CMHC's mortgage insurance operations, and the lack of new CMHC-insured rental housing loans, there would seem to be some room to manoeuvre by taking greater risks on rental mortgage insurance.

Province should have contingency plan

If the federal government rejects the notion of using surplus funds to improve financing conditions, the province should hold discussions with private sector financial or underwriting institutions that might be willing to develop competitive rental housing financing products.

- These discussions could focus on expanding the range of financing opportunities available to rental developers, and determine what barriers these organizations see to entering the mortgage insurance field. After better understanding these issues (and risks) and, depending on the extent to which the federal government was encouraging CMHC to provide a more sympathetic mortgage insurance environment, the province could consider a more direct role.

In general, it is the view of the Working Group that a competitive mortgage insurance market is the best outcome to strive for, so conditions that would encourage the private sector to compete with CMHC for mortgage insurance business should be explored.

Form a provincial mortgage insurance operation

Ontario could try to replicate CMHC's mortgage insurance function through a provincial mortgage insurance corporation. This would be a significant undertaking – highly skilled staff would

be required; the potential risks of loan defaults are substantial; competing with CMHC for rental insurance business could be difficult. Since the federal government guarantees its loans, CMHC would probably be the first choice for most potential rental investors. CMHC would then retain the lion's share of the low-risk (low LTV) loans which bolster mortgage insurance premium income without adding much to the risk exposure of CMHC's Mortgage Insurance Fund.

For the most part, a provincial mortgage insurance entity would likely compete for the business of potential rental investments that could not secure adequate financing from CMHC. These would be higher-risk projects that CMHC would probably prefer not to underwrite – a problem of adverse selection that would skew the province's risk exposure. In the event of a major downturn in the rental market, the province would be exposed to potentially very significant losses, without the benefit of lower-risk projects to balance out the risks.

On the other hand, if a provincial mortgage insurance corporation were able to secure a significant share of the low-risk rental loans in competition with CMHC, normal market pressures would tend to move CMHC to modify its premiums and other requirements in order to be more competitive.

On balance, given the substantial risk and effort in starting up such an enterprise, and given that Ontario has actively moved away from the direct provision of services, this approach is not recommended.

Rental Housing Financing: Lessons Learned

Building upon the changes CMHC has already implemented, it is important to find additional ways to encourage greater flexibility in terms of CMHC's mortgage insurance and underwriting practices, and their risk mitigation requirements. The first step should be to engage the federal government in dialogue about the use of the surplus dollars in CMHC's insurance and guarantee funds.

The second step is to work with the federal government to facilitate conditions for a more competitive market and to create a more level playing field for potential private sector competitors for CMHC. Clearly, in the long run, a competitive market for mortgage insurance represents the best solution for the rental supply issue.

This step would include asking the federal government to review the *Bank Act* to examine the possibility of allowing federally chartered financial institutions to offer property loans in excess of the 75 per cent LTV maximum currently allowed. Uninsured loans of 80 per cent are common in the U.S. and allowing similar flexibility to Canadian financial institutions would facilitate more creative high-ratio financing without requiring the participation of CMHC.

As a third step, depending on outcomes in the first two areas, the province should hold discussions with private sector financial or underwriting institutions that might be willing to develop competitive rental housing mortgage insurance products.

Establishing a provincial mortgage insurance entity in competition with CMHC is not recommended. Either partnering with CMHC, or working with private sector financial institutions to facilitate easier access to mortgage financing would appear to offer greater potential and more manageable risks, than attempting to compete directly with CMHC.

5. Learning from the U.S. Experience

Research done for the Working Group identified and described the key government tax and housing program measures that have helped to spur new, market rental development in the United States.[15] While there are lessons to learn from the U.S. experience in rental housing, there are important differences between Canada and the U.S. in market conditions and in the level and kind of government intervention in each case. These differences make direct comparisons difficult in assessing the applicability of the U.S. model to the Canadian market.

Differences in Rental Housing Production

Similar trends in rental production occurred in Canada and the U.S. through periods of boom and bust between 1970 and the early 1990s. Rental completions in the U.S. dropped from an annual average of over 314,000 units in the 1970's to 165,000 units during the early 1990s recession period. In the latter part of the past decade a building boom restored new rental production to about 225,000 units per annum. This level of activity represents just over 16 per cent of all new housing starts in the U.S.; the comparable figure for Canada is 9 per cent for the last decade, but the current proportion in Canada is much lower, given the decline in social housing starts in Canada in recent years. Factoring out U.S. rental units assisted by various federal subsidy programs, recent levels (since 1995) of private unassisted rental production are proportionately more than double that of Canada. However, on closer inspection, the higher level of private unassisted rental production in the U.S. is largely explained by significant regional variations due to underlying development fundamentals which favour new rental investment particularly in the U.S. south.

Key Factors Driving U.S. Production

Higher production levels in the U.S. (on a proportionate basis) are affected by several factors, including direct and indirect government subsidies, favourable tax treatment, a more competitive financing system and marked geographic and demographic influences. Financing is also influenced by critical legislation requiring lenders to offer loans in low-income communities, which has promoted a proactive involvement of the private finance sector. An understanding of these factors is useful in terms of placing the U.S. experience in new rental development within its particular context and assessing the potential for applying aspects of the U.S. system to the Canadian market.

Government subsidies

Proportionately higher rental production in the U.S. is markedly influenced by a range of direct publicly funded subsidies (i.e., grants and loans)

15 Greg Lampert and Steve Pomeroy, *The Context for Private Rental Housing Production in the U.S.*, 2002

and indirect (i.e., tax-based) subsidies. Although the form of subsidy programs has varied over time, it is notable that there has never been a large scale or absolute withdrawal of the government from the subsidy area (except a short-term moratorium in 1974). Instead, the U.S. has continued to experiment and refine programs, so that overtime a comprehensive "system" of support has evolved. The main programs currently in place include:

- The Low Income Housing Tax Credit (LIHTC), initiated in 1986, as a result of joint efforts by the industry and affordable housing advocates in the face of major tax reform that had negative implications for both unassisted and affordable rental development. The LIHTC distributes federal tax credits (over $300 million/year, continuing for 10 years) that are sold to investors, with the proceeds used as equity for investment in affordable housing projects (average 75,000 units/year, annual expenditure over $3.5 billion). Investors have a built-in incentive under this program to sell to a non-profit operator after the 10-year tax benefit period, a step that ensures that the initial public investment remains intact.

- Preferential bond financing, which allows state and local governments to issue tax-exempt bonds to finance targeted affordable housing development or rehabilitation through for-profit or not-for-profit corporations.

- The Community Development Block Grant (CDBG), initiated in 1974, offers formula-driven federal block funding to local government for a range of redevelopment purposes, including new rental development. Funds must be used in income targeted initiatives that are locally designed and managed – the federal government provides the funding and qualifying conditions.

- The HOME investment partnership program, similar to the block grant (CDBG), which provides formula-driven funding for a range of new rental, rental rehabilitation and assisted home ownership housing projects.

- A variety of other, smaller programs in support of assisted housing, including a mortgage insurance program under the Federal Housing Administration in support of affordable housing financing.

The success of the U.S. subsidy programs reflects a high level of government support for assisted rental development in that country. Together, they account for about 47 per cent of all new rental development in the U.S. over the past ten years. The four main programs involve annual federal expenditures over $10 billion. Moreover, the length of time most of these public supports have been in place has provided a degree of certainty and stability in the marketplace that has often been missing in Canada. In addition, it is important to note that the U.S. subsidy programs are typically accessed in combination, and this "layering" of programs has created a more comprehensive system.

This system, with its history of steady success, seems to fit the U.S. market well, builders, investors and lenders alike, and at the same time serves a public policy agenda that supports initiatives to meet the needs of moderate income households. Most of these programs are targeted based on income. Typically income targets are based on a ratio of Area Family Median Income and range from 60 per cent (LIHTC) to

120 per cent (mortgage bond financing). Effectively, this means that units are targeted to moderate income employed households – for example, young families starting out in teaching, police, fire professions, but not necessarily households with the lowest income levels. In this sense, most programs generate market rate housing that approximates mid market rents. Additional grants or ongoing shelter allowances are used to address very deep need.

Many initiatives are broader than just new rental development – they include rehabilitation and assisted ownership programs, often as part of broader neighbourhood revitalization efforts. In essence, the private sector is a *de facto* partner in working towards policy targets for affordable rental production.

Favourable tax treatment

U.S. investors benefit from more favourable tax rules than their Canadian counterparts. This is particularly true with respect to the treatment of capital gains and asset depreciation, both areas where recommendations for more favourable and somewhat comparable taxation are recommended in this report.

In the U.S., investors can "pool" their properties for purposes of capital gains in such a way that, when a property is sold, the sale is treated in terms of the pool, not as a single property. As well, investors can fully defer capital gains or recaptured depreciation tax liabilities on the sale of a property if they invest in another property of equal or greater value. These advantages improve market liquidity and ensure that funds are available for reinvesting in new rental development.

In terms of depreciation, U.S. rental properties can be depreciated at a faster rate, based on a *straight-line* depreciation (effective rate of 3.64 per cent, with the depreciation amount pro-rated in the first year) over 27.5 years. This is more favourable than the Canadian system, which is based on a *declining balance* (4 per cent/year, with half of the depreciation amount allowed in the first year). U.S. investors are able to reduce taxable income further, thereby improving after tax returns.

Market fundamentals and demographics

Interestingly, the highest levels of U.S. rental development (60 per cent of all rental housing) are found in the southern U.S. states, which tends to skew the total U.S. picture. High production volumes occur in the south for a number of reasons – the demographics of a high growth, high demand area, lower land development costs, fewer growth controls, a positive investment climate, a predictable regulatory climate, and lower property taxes and local fees/charges, to name a few.

Critical factors for growth in new unassisted rental supply are the presence of sound market fundamentals (e.g., low cost/high returns) and the nature of the marketplace itself (e.g., history and nature of the government/industry relationship, demographics and supply/demand features). This is readily illustrated by the significant impact on U.S. national housing production levels of unassisted rental production in the south, where strong market conditions prevail.

Influence of the condominiums sector

A major difference between U.S. and Canadian markets exists in the condominium sector. In the U.S. market, rental construction accounts for about 80 per cent of multi-unit starts – condominiums account for less than 20 per cent. In Canada, however, the situation is reversed. Condominium development is the norm in Canada, especially in the largest urban centres, where land is more expensive. Since condominiums tend to offer better returns to investors, they command high values and this in turn has the effect of driving up land values, often to the point where rental development cannot compete, except at the luxury end of the spectrum.

Access to financing

The main difference in financing between the two countries lies in the greater diversity and competitiveness in the U.S. market, which is generally favourable for borrowers. The Canadian market, in contrast, is heavily influenced by CMHC's controlling role in underwriting mortgage insurance, a legislated requirement for new rental construction when the loan exceeds 75 per cent of value. Differences also emerge in terms of the criteria used to determine mortgage eligibility. In the U.S. market, rental developers can obtain uninsured loans at 80 per cent LTV; these loans carry a risk premium in terms of higher interest rates. Minimum debt coverage ratios (DCRs) in the U.S. are similar to the new ratios announced by CMHC (i.e., 1.25 – 1.30), but U.S. loans do not require the same onerous guarantees and covenants as higher ratio insured CMHC loans.

In addition, U.S. banks are required by legislation to offer loans in communities where they make a profit, including low-income communities. This requirement is in place to reduce or offset discriminatory lending practices, precluding minorities as well as geographic redlining of poor neighbourhoods. The *Community Reinvestment Act*, adopted in 1978, is a very significant influence in engaging the U.S. private finance sector in affordable housing issues.

Although access to financing for private rental housing does not appear to be a problem in the U.S. and is, on balance, similar to that in Canada, the terms of private sector financing for affordable rental housing are better in the States.

Lessons Learned from the U.S. Experience

A review of the significance for Canada of the U.S. experience in rental housing development offers the following lessons:

- The U.S. experience clearly shows a variety of factors determine the viability of rental development. A key issue is getting the market fundamentals 'right' and removing any critical impediments. Second, once the fundamentals for creating a fair and attractive playing field that encourages private development are in place, additional measures are necessary to create the incentive structure to generate production at more affordable levels and to ensure that affordability is sustained (in the American example through incentives for long term ownership by the non-profit sector).

- In much of the U.S. outside of the south, the same problems of low supply and limited affordability prevail, as they do in Canada. Southern states display the strongest market fundamentals, where values exceed costs due to low labour and land costs. These lower costs are a function of minimal growth control and development in lower-cost suburban locations. As well, lower levels of property tax and development charges reduce the public cost component associated with development. It is possible that many U.S. municipalities are able to operate with lower revenues from these two sources because state and federal governments are relatively more generous in providing block grants and fiscal transfers to help pay the costs of growth. More research is required to understand how intergovernmental fiscal arrangements in the U.S. influence cost issues facing new rental development, and the impact of similar policies in Ontario. In any event, serious public dialogue is now taking place in Ontario with respect to further revenue sources for Ontario's municipalities, and housing – a relatively new responsibility for the municipal sector – should not be overlooked in this dialogue.

- Consideration of local charges should be viewed in the broader context of government taxing capacity, fiscal transfers and service burdens. In this sense, exploring the possibility of federal and provincial funding to help pay the costs of growth in local communities may be warranted. In Ontario, for example, municipalities clearly feel there should be federal funding associated with the extraordinary financial strains placed on municipalities struggling to absorb and provide for enormous numbers of new Canadians each year. Furthermore, the U.S. model of tax-exempt bond financing to enable municipalities to raise capital for housing and other growth-related investments should be explored in more detail. Our understanding is that Ontario is now exploring the idea of tax exempt bonds and we certainly endorse this step. Housing should be included in the eligible uses for the capital funds raised in this manner.

- The U.S. has developed a supplementary subsidy system that is market based and monitored. The tax subsidies through tax credits (e.g., the LIHTC) attract private equity investment and these investors ensure that their investment is protected. This approach actively engages private investors and fosters a more competitive market. At the same time, the public policy framework is designed to ensure positive public outcomes – particularly incentives for private investors to transfer ownership to the non-profit community sector and to ensure long-term preservation of the affordability objective.[16]

- There has been less focus on the tax system in the U.S., as the major reform occurred in 1986, removing accelerated depreciation and very favourable tax treatment, although even after these reforms, the tax treatment of rental investment is still more favourable in the U.S., particularly with respect to pooling, rollover provisions and depreciation and the absence of a federal sales tax. After tax reform, the Low Income Housing Tax Credit (LIHTC) replaced the more favorable general tax treatment with a much more targeted tax expenditure program. To the extent that the LIHTC has become the primary vehicle for moderate rental development, the U.S. has not pursued any additional tax reform. While a tax credit, access to the LIHTC is more

16 This approach encourages investors to sell to a non-profit operator after the 10-year tax benefit period, which ensures that affordability objectives continue, thereby preserving the objectives of the initial public investment.

limited than "as of right" for qualifying development, with a complex delivery system involving state housing finance agencies which allocate the federal credits through a competitive process to qualifying rental projects.

- Access to financing is generally not an issue with respect to *unassisted* rental development in the U.S., but it has been a concern in the *assisted* or *affordable*[17] housing sector. In the U.S., the federal government's public mortgage insurance approach has an almost exclusive focus on financing affordable housing. This includes direct subsidies for mortgage insurance premiums in publicly operated mortgage insurance programs (e.g., FHA multi-family insurance). It also requires 'government sponsored enterprises' – private corporations originally created as public agencies (e.g., Fannie Mae, Freddie Mac), that enjoy an implicit guarantee from the federal government giving them a very competitive credit rating – to meet affordable housing goals by ensuring that mortgage financing is made available for affordable multi-unit rental development.

- For the unassisted private market, strong market conditions are the key to a viable production system. As discussed, significant levels of unassisted production are found in the southern U.S., where market conditions appear strongest. The tax and regulatory systems also provide benefits for these markets. More limited levels of unassisted development, similar to Canadian levels on a proportionate basis, characterize most other U.S. areas. In essence, the fundamentals are not working in most regions of both countries – except at the high end of housing markets. That said, clearly, the kind of improvements suggested in this report would have a significant impact on creating more conducive market conditions.

- Public policy can influence market con-ditions. Policies related to property taxation and rent control, for example, can impact net operating income (NOI) and thus property values and the motivation to invest. Ontario has already introduced the *Tenant Protection Act*, which allows rents to move to market levels when units become vacant on tenant turnover, and created the option for municipalities to lower property taxes and other charges. As such, the possibilities for further actions at the local level to enhance the valuation of new rental development may be limited.

On balance, the U.S. approach is more conducive to new rental development. It is clear that the U.S. has accepted that rental housing is a mixed marketplace and that over time Americans have evolved a more balanced approach, with the private sector, the public sector and the non-profit sector all playing active roles. Included in this mix is a dependable and reasonably stable financial environment for making a portion of the overall rental production affordable for those with modest income. The U.S. also puts up fewer market barriers and helps subsidize the cost of mortgage insurance for the limited situations in which insurance is available.

17 'Affordable' housing in the U.S. tends to link more closely to younger, employed entry-level workers (mid-range area median incomes of $30,000 to $40,000) in the trades and junior professions, and is a surrogate term for 'market rate' housing.

Over the next few years, as the various levels of government in Canada move to improve market conditions and support the development of affordable housing, there is obviously much to be learned from the American experience. Knowing that all sectors need to be actively engaged, that the market and tax environments need to be more encouraging to investors and that significant government financial support in the form of rent supplements and/or shelter allowances is still necessary to achieve affordability for those most in need is particularly instructive. As noted earlier in the report, our preference is for shelter allowances which is a market mechanism which provides support directly to those in need allowing them to choose their own housing and, in turn, fosters competition in the market place for their business.

In general, the U.S. experience has tended to create a more constant and predictable environment for investors. Since tax reform in 1986 and the emergence of the Low Income Housing Tax Credit as the major tax expenditure vehicle to encourage affordable housing, changes to the tax and program environment have been relatively minor, which in turn has given confidence to individuals and corporations considering long term investments in rental housing. The importance of a relatively constant and predictable environment for investors can not be overstated.

6. Conclusions

Stimulating New Rental Housing Supply

The main reason behind the lack of investment in new rental housing production in Ontario is that this type of investment is not economically viable. Fundamental conditions in the marketplace are contributing factors (e.g., the impact of competition from the province's very active condominium market in driving up land prices), but as well, the regulatory and tax systems have contributed by discouraging investment in new rental development. With a more buoyant economic outlook, builders appear to be interested again in entering the market, especially at the luxury end, which offers higher income streams and potentially higher rates of return. Even high-end rental production will help in terms of creating market liquidity and new opportunities for alleviating some of the pressure on the available stock. New high-end rental attracts higher income tenants and thereby frees up existing lower priced stock for other tenants. Having said that, however, it must be an objective of governments to encourage developers to build for mid-range rental markets – and this has been a recurring theme in Working Group discussions.

The rental housing supply issue is complex and multi-faceted. Three levels of government are involved, together with important players in the banking, insurance, housing development and institutional investment communities. Also involved, are those who are in the market for rental accommodation, existing renters and community-based proponents for affordable housing including housing for the homeless families and individuals most in need. While demand-side solutions in this area are clearly also a matter for government policy consideration, the most significant *market* improvements can be effected through joint government action to improve business conditions and how the system operates. Government action to spur market conditions that are more conducive to new rental development in all price ranges is possible – and is urgently required. In our report we have stressed changes to the tax and mortgage insurance environment as important next steps.

On the question of joint action, the U.S. experience is instructive. There, the marketplace works best where there is a "mix" of public, private and non-profit sector involvement. Experienced private developers generate reasonable levels of rental production by working actively and in concert with government support programs and with the non-profit sector to ensure a supply of rental stock in general, as well as affordable (and often heavily subsidized) rental stock.

Expectations about roles, relationships and outcomes across all three sectors in Canada do not appear to be as clearly developed or as fully evolved as they are in the States. Nor will it be easy to replicate or transplant U.S. solutions to the Canadian housing environment. However, a clear and constant delineation in the roles of the private and non-profit sectors and government is important to ensure an active affordable housing sector. The U.S. experience seems to suggest that the "developers risk" is best taken only by the private sector; yet there is a very active role for the non- profit sector in partnering with

private developers and in managing affordable housing development focused on community needs. A recurring theme of the research done for the Working Group is that the regulatory and tax environment should not adversely affect the feasibility of rental housing development. This is particularly important for the private sector, which has been virtually absent from the production of rental housing for many years.

In Canada, over the years, in terms of rental housing policy, there has been too much fickleness and flip-flopping in relying on one sector or another. There has been too little attention paid to the underlying health of the marketplace. Furthermore, there has not been the sustained effort needed to build a strong, balanced rental sector where all key players know their roles and can play them effectively, and where housing appropriate for a wide range of consumers is produced.

Next Steps

The Working Group has received expert advice on three key issues raised in the Working Group's first report: the impact of potential changes to the federal tax system, the impacts of CMHC's mortgage insurance requirements and premiums on rental investment decisions, and the dynamics of the major U.S. tax and housing related program levers were examined in detail.

Based on the research which we commissioned we believe that there is a strong case to be made for government action in the areas which we have looked at in this report. Improved tax treatment for rental housing, and a less onerous more supportive mortgage insurance environment will clearly stimulate more rental housing development. Ultimately, we feel a private sector presence in the mortgage insurance market would create a competitive market that would benefit participants. It would also appear that there are some changes to the *Bank Act* and to capital reserve requirements for private mortgage insurers that are reasonable and which would create a more competitive financial market.

We recognize that all levels of government are now actively aware of the importance of ensuring that business conditions for the production of rental housing are improved. Many improvements have already been made by the federal, provincial and municipal governments and it is our belief that the implementation of the recommendations in our report should form the basis for the next round of improvements. Obviously market fundamentals in the form of interest rates, land prices, etc. will continue to be dominant factors – but even when the fundamentals are favourable, as most of them are today, without the kind of improvements we are advocating, rental housing is still only being built in very limited quantities. With the changes recommended in this report this should no longer be the case.

Finally our research indicates that the cost to government of these changes is not great. Clearly, the production of new rental units creates economic activity and additional tax revenue. Further, it appears that this additional revenue makes up for some if not all of the direct tax revenue that might be lost if these measures are implemented.

Currently, builders appear to be interested again in entering the market, especially at the luxury end, which offers higher income streams and potentially higher rates of return. As mentioned earlier, high-end rental production may help to create market liquidity and new opportunities for loosening the pressure on available stock. New high-end rental attracts higher income tenants, thereby freeing up some existing lower priced stock for tenants. However, an ongoing objective of governments must be to encourage developers to build for mid-range rental markets – and this has been a recurring theme in Working Group discussions. We believe the implementation of the measures reviewed in this report will be a major step to achieving this goal.

7. Summary and Recommendations

Tax Changes to Spur Investment

The first area for action is to take the necessary supportive steps to enable the rental market to "self-correct" and return to a more positive investment climate. One dimension of this more positive climate has to do with taxation and opportunities to lower development costs and improve after-tax returns, especially in the crucial early years of new rental projects. Analysis indicates that, on a present value basis, after-tax returns under the 1980 tax rules for three key changes (soft costs, capital cost allowance, and lower federal sales tax) are about 21 per cent higher than under current rules. (While corporate tax rates were higher during the earlier period and would have lowered the investment returns at that time, the higher rates in 1980 applied to all types of corporate income so rental investment returns in 1980 would still have been relatively more attractive compared to alternative investments than is the case today.)

There are a number of potential tax changes identified in this report that the federal government can make to restore more attractive tax conditions and provide greater flexibility in the tax treatment afforded new rental housing. This report recommends that *all seven* tax measures be tabled for consideration by senior government levels as part of the broader housing agenda. However, from an effectiveness standpoint, special attention should be paid to four of the measures – *fully rebating the GST on new rental housing; deferral of capital gains tax and recaptured depreciation (upon reinvestment in new rental housing); increasing the CCA rate to 5 per cent; and restoration of soft cost deductibility ($5,000).* At the same time, the province should consider a similar review of its application of provincial sales tax (PST) in rental housing projects, and the options for changes that would parallel any changes in federal tax policies.

There are dividends to the federal government from making these changes. For example, cost-benefit analysis suggests that just three of the measures (full GST rebate, increase of CCA rate to 5 per cent, immediate deductibility of soft costs ($5,000)), yield net revenues to the federal government that more than cover the revenue losses due to tax changes. For these measures, production of 6,000 or more incremental units (i.e., new units attributable to the introduction of the measures) fully covers the costs incurred by extending all three changes. *Development over and above this level will generate an overall net gain in federal revenue.*

Of course, the net increase in housing starts (and the corresponding impact on government revenues) will depend on the extent of the tax changes and developer assessment of the impacts for their own business case. There may also be some substitution effect wherein higher rental starts are offset somewhat by lower condominium starts. However, since there are such

extremely tight rental markets in most urban centres in Canada, there would appear to be ample room for a significant increase in rental starts without major reductions in other housing starts.

It is recognized too that the tax changes will have an impact on provincial revenues and there is a need for additional analysis in that respect. However, a cost-benefit of two of the measures (increase of CCA rate to 5 per cent, immediate deductibility of soft costs ($5,000)) when quantified shows net benefits for Ontario that at least partially offset the costs of the tax changes.

A real effort will have to be made by industry and by all those interested in the housing "file" to work with the respective Ministers of Finance to effect the necessary changes. CMHC should be an active partner in this effort. In addition to seeking consensus at a national level, the provincial and federal governments should work bilaterally on areas of mutual concern in this area. For example, these discussions should include the adequacy of current municipal fiscal arrangements in consideration of the local charges now required to cover the costs of growth in local communities.

Discussions should also include the potential benefits of designing and instituting a form of tax credit, based on some adaptation of the U.S. model, to leverage private equity investment in rental projects. Finally, in conjunction with its discussions with the federal government on these matters, the province should explore in detail the potential for implementing a form of tax-exempt bond financing to enable municipalities to raise capital for housing and other growth-related investments.[18]

Recommendation #1:

The province should table for discussion with federal/provincial/territorial partners the following changes in tax measures affecting new rental housing, in order of priority:

- **a full rebate of the Goods and Services Tax (GST) on new rental housing;**
- **deferral of capital gains tax and recaptured Capital Cost Allowance (CCA) upon sale of a property and re-investment in new rental housing;**
- **increase in the CCA rate to 5 per cent for new rental housing;**
- **restoration of soft cost deductibility (up to $5,000) for new rental housing, with negotiation on the definition of soft costs;**
- **elimination of the capital tax on rental housing;**
- **allowing small landlords to qualify as small businesses; and**
- **extension of eligibility for CCA losses to all investors in new rental housing.**

Recommendation #2:

The Ontario Ministry of Finance should explore with the federal Department of Finance the possibility of designing a tax

18 The 2002 Provincial Budget announced the provincial government's intent to introduce tax-free opportunity bonds. The province plans to consult with municipalities on how municipalities can use money raised through tax free opportunity bonds to lower municipal financing costs for infrastructure investments. As currently conceived, municipalities would not have the authority to issue such bonds themselves, but could access funds raised through bond issuance, by application to a provincial financing agency.

credit along the lines of the U.S. model (i.e., a targeted output – to low income households), with a provincial component that would allow federal/provincial sharing of tax expenditures.

Recommendation #3:

The province should, in cooperation with the Association of Municipalities of Ontario (AMO) and the municipal sector, move as quickly as possible to implement a form of tax-exempt bond financing to enable municipalities to raise capital for housing and other infrastructure and growth-related investments.

Risk Management and Project Financing

The second area for action focuses on ways and means for continuing to improve the financing options available for new rental housing, by adopting the progressive strategy described in this report. This strategy includes:

- As a first step, requesting the federal government to direct CMHC to use surplus funds generated by the Mortgage Insurance Fund (MIF) and Mortgage-Backed Securities Guarantee Fund (MBSGF), to reduce its risk exposure and offer more favourable underwriting criteria;
- Addressing concerns about risk assessment in rental project loans, including access to loans and mortgage insurance, red tape, and the methods used to determine loan amounts and conditions. In this area, recognition needs to be given to the fact that certain unilateral changes have already been made (e.g., with respect to CMHC business arrangements and requirements), and that steps need to be taken to evaluate the pace and impact of these changes over time;
- Encouraging the federal government to help foster more competitive market conditions by reviewing policies that contribute to restricted competition in financial services directed to the rental housing industry (for example, restrictions placed on chartered bank mortgage financing under the Bank Act, and other requirements under mortgage insurance rules such as capital reserve requirements);

The primary objective should be to persuade the federal government to allow surpluses generated by the Mortgage Insurance Fund to be used to reduce premiums or to ameliorate underwriting criteria. It is also noteworthy that in the U.S., the mortgage insurance that is sponsored through government is subsidized to meet affordability objectives. However, as a contingency, the province should be prepared to establish closer ties with commercial ventures that might be willing to develop competitive rental housing mortgage insurance products. In general, it is the view of the Housing Supply Working Group that a competitive mortgage insurance market is the best long term outcome.

Recommendation #4:

The province should continue bilateral discussions with the federal government on more flexible financing terms for rental development, with particular focus on the reinvestment of MIF surpluses, CMHC's package of risk mitigation measures and opportunities for enhancing the flexibility

of CMHC's mortgage insurance underwriting practices. More specifically, the federal government should dedicate CMHC surpluses to the MIF reserves in order to provide greater risk capacity and enable CMHC to adopt less stringent mortgage insurance requirements. CMHC should also develop mortgage insurance products particularly suited to affordability objectives such as projects serving those most in need.

Recommendation #5:

The province should urge the federal government to undertake a comprehensive review of the ways in which federal policies act to restrict competition in the area of housing financing. In particular, the federal government should be asked to review requirements for mortgage insurance on high ratio real estate loans in the Bank Act, and for additional capital reserves for lenders dealing with private mortgage insurers.

Recommendation 6:

As a contingency in the event the federal government is unwilling to consider changes to their mortgage insurance provisions, the province should hold discussions with private sector financial or underwriting institutions. Such discussions could focus on provision of mortgage insurance and/or expansion of the range of financing options available to rental developers.

Recommendation #7:

CMHC should monitor, assess and report publicly the pace and impact of the business practice changes implemented in 2002 by CMHC. These changes are an important first step and signal CMHC's willingness to adjust their pricing and underwriting policies as circumstances permit.

Collaboration and Partnership

What is required immediately in Ontario and, as well, for most other parts of Canada, is joint action on several fronts. Three levels of government, and especially the two senior levels initially, must continue to work together to improve business conditions conducive to new rental development. In order to fully engage and inform the discussion on rental housing supply, this matter should be part of a national agenda dealing with housing issues. Within the sphere of responsibility for each level, the research suggests that there are clear options to consider.

The Housing Supply Working Group also continues to believe that uncertainty with respect to the future of the *Tenant Protection Act* requirements is a significant impediment to investment in rental housing. We continue to support the recommendation in our first report urging that "Possible mechanisms be explored which would enhance stability for investors in the future through contracts, performance bonds or other measures. Such binding assurances would improve access to capital and encourage long-term financial commitments."

In addition, the existing ability to convert rental units to ownership is an important feature of the current regulatory environment and should be maintained. We also welcome the response to our earlier recommendations regarding PST offset grants. Providing such grants to units in the new Affordable Housing Program is a good step, however, we also would continue to urge the government to provide sufficient funding so that the grant can be made available to all new rental units. As well, we continue to believe that the rebate should apply to purpose built rental units that are condominium registered, that consideration should be given to eliminating the PST on mortgage insurance for home owners and that similar consideration be given to extending the offset grant to building materials used in the construction of affordable ownership homes.

With respect to municipal roles and responsibilities in new rental development, the direction in the short run should include exploration of the potential for easing the cost burden from various municipal charges. These discussions should be aimed at encouraging municipalities to use their permissive authorities in these areas, and should be considered in the context of overall provincial/municipal fiscal arrangements.

In addition, the potential for stronger collaboration and partnership between the province and the private sector should be examined and communicated.

Recommendation #8:

The province should ensure that business conditions necessary for stimulating new rental housing development are tabled as priority agenda items for both federal/provincial/territorial housing discussions and for provincial/municipal discussions and that municipalities be included in discussions regarding those issues that are important to them.

Recommendation #9:

The province should continue to work with municipal partners to ensure a level playing field concerning the treatment of new rental housing projects in areas such as property tax, local development charges, approval procedures and administrative requirements.

The province should also monitor the level of municipal discretion exercised under the Fair Municipal Finance Act with respect to property tax treatment of new rental housing.

Appendix A: Bibliographic References

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Appendix B: Working Group's Interim Report Recommendations

Recommendation 1: Federal Tax System

It is recommended that the province and industry work with the federal government to identify key changes to the tax system, which would stimulate rental supply. This should include consideration of rollover provisions; pooling; passive vs active designation; GST, and Capital Tax. In particular, given the conclusions of the Ernst and Young study comparing rental economics in the U.S. with those in Ontario, it is recommended that particular attention be paid to the ability to rollover capital gains tax and the amount of allowable annual CCA deduction

Recommendation 2a: CMHC Lending Practices

It is recommended that the province and industry work with the federal government to identify changes to CMHC lending practices, which would encourage rental development. This would include reviewing insurance fees for high ratio loans for rental housing and the determination of lending value for rental housing.

Recommendation 2b: Direct or Indirect Provincial Provision of Mortgage Insurance

It is further recommended that, in the absence of federal government action to address the current disincentives with respect to CMHC mortgage insurance, that research be undertaken to determine the feasibility of the province providing mortgage insurance for rental housing construction, directly or underwriting CMHC mortgage insurance.

Recommendation 3: LIHTC and Shelter Subsidies

It is recommended that the federal and provincial governments consider U.S. type tax incentive systems such as the Low Income Housing Tax Credit as well as shelter subsidy programs to promote affordability in a private market.

Recommendation 4: Separate Tax Class for New Rental Extension

It is recommended that the province provide municipalities with authority to provide favourable property tax treatment (same as ownership housing) indefinitely. This would replace the current authority, which provides favourable property tax treatment for a maximum of eight years.

Recommendation 5: Agreements for Affordable Housing

The province should allow municipalities to enter into agreements with the private sector for the creation of affordable housing under section 210.1 of the *Municipal Act*, which would enable municipalities to provide a financial incentive to a private sector corporation for th . development of affordable housing.

Recommendation 6: Municipal Impediments to Rental Development

It is recommended that the *Development Charges Act, the Education Act* and the *Planning Act* be reviewed by the province to ensure that development charges, planning fees and municipal approvals processes do not discourage the development of affordable housing. As well, the impact of other municipal impediments to affordability such as section 37 charges on rental should be looked at as well as measures to encourage zoning and approval of rental housing.

Recommendation 7: Zoning for Accessory Apartments;Equal Tax Rates for Ownership and Rental

The Housing Supply Working Group also believes that further consideration should be given to the following issues, with recommendations developed at a later date, as appropriate; encouraging municipalities to adopt zoning that allows for accessory apartments; and encouraging municipalities to equalize tax rates between ownership and rental housing.

Recommendation 8: PST Grant to Condominiums

It is recommended that the current PST offset grant of $2,000 per affordable rental unit constructed be extended to include condominium registered rental units as well as purpose built rental.

Recommendation 9: Extension of PST Grant

It is recommended that the [PST] program funding be increased so as to be available for all eligible applicants and that the program be extended beyond 2002.

Recommendation 10: No PST on House Mortgage Insurance

It is recommended that consideration be given to eliminating the PST on mortgage insurance for homeowners.

Recommendation 11: PST Grant for Houses

It is recommended that consideration be given to extending the current PST offset grant to building materials used in the construction of affordable ownership homes.

Recommendation 12: Compensation for Changes in Rent Control

Possible mechanisms be explored which would enhance stability for investors in the future through contracts, performance bonds or other measures. Such binding assurances would improve access to capital and encourage long term financial commitments.

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